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INSIGHTS

ALTA ENERGY AFFIRMS TREATY BENEFITS: A CANADIAN CASE STUDY FOR APPLYING THE M.L.I.

A DEEP DIVE INTO G.I.L.T.I. GUIDANCE

C-CORPS EXEMPT FROM FULL SCOPE OF FOREIGN INCOME INCLUSION

HOW TO HANDLE DUAL RESIDENTS: THE I.R.S. VIEW ON TREATY TIE-BREAKER RULES

AND MORE

Insights Vol. 5 No. 10

TABLE OF CONTENTS

EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **Alta Energy Affirms Treaty Benefits: A Canadian Case Study for Applying the M.L.I.** As part of its attack on B.E.P.S., the O.E.C.D. published its Multilateral Instrument, a device that revised more than 1,200 income tax treaties. One of the provisions of the M.L.I. targets treaty shopping by the adoption of, among other things, a principal purpose test ("P.P.T."). In simple terms, the P.P.T. disallows a treaty benefit when a principal purpose of a transaction is to obtain that benefit. Transactions in accordance with the object and purpose of the provisions of a treaty are not affected by the P.P.T. Many North American tax advisers know that the P.P.T. is based on a provision of Canadian law known as the General Anti-Avoidance Rule or G.A.A.R. A recent decision of the Tax Court of Canada addresses the application of G.A.A.R. to a cross-border tax plan set up by a U.S. financial institution designed specifically to obtain enhanced Canadian tax benefits by rechanneling a U.S. investment in Canada into a U.S. investment into Luxembourg that was then invested into Canada. The Canada Revenue Agency ("C.R.A.") attacked the Luxembourg company's entitlement to treaty benefits relying heavily on G.A.A.R. Kristy J. Balkwill and Benjamin Mann of Miller Thomson L.L.P., Toronto, explain the decision and its potential impact on the P.P.T. The case has been appealed by C.R.A.

- **Revised Swiss Corporate Tax Reform Will Keep Switzerland a Top Corporate Location.** Beginning in 2015, Switzerland has struggled over the adoption of a tax system that is consistent with B.E.P.S. Many different stakeholders are involved, ranging from the Swiss Federal government to the cantons, various political parties, and the E.U. At last, a version of tax reform has been adopted by the Swiss Federal National Assembly. Known as the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F."), it contains provisions designed to please all participants while maintaining Switzerland's global reputation as an attractive jurisdiction for multinational enterprises. Danielle Wenger and Manuel Vogler of Prager Dreifuss AG, Zurich, guide the reader through the various iterations of the reform and the provisions of the T.R.A.F.

- **The U.K. Digital Sales Tax – It Could Be You.** On November 7, 2018, the U.K. government confirmed that it will proceed with the introduction of a digital services tax ("D.S.T.") on large businesses. The tax will be charged beginning April 2020. It will apply to three key areas, which the government has concluded derive a huge value from the participation of U.K. users and are largely untaxed. Eloise Walker of Pinsent Masons, London, provides an overview of the D.S.T., cautioning that problems exist in identifying both the revenue to which the D.S.T. will apply and the hallmarks of jurisdiction that must exist in order for the tax to be imposed.

- **A Deep Dive into G.I.L.T.I. Guidance.** The I.R.S. has published proposed regulations on the global intangible low-taxed income ("G.I.L.T.I.") regime, which is applicable to those controlled foreign corporations that manage to operate globally without generating effectively connected income taxable to the foreign corporation or Subpart F Income taxable to its U.S. Shareholders. In a detailed article, Rusudan Shervashidze, Elizabeth V. Zanet, and Stanley C. Ruchelman examine the proposed regulations and all their complexity.

- **C-Corps Exempt from Full Scope of Foreign Income Inclusion.** One of the principal highlights of the T.C.J.A. is the 100% dividends received deduction ("D.R.D.") allowed to U.S. corporations that are U.S. Shareholders of foreign corporations. At the time of enactment, many U.S. tax advisers questioned why Congress did not repeal the investment in U.S. property rules of Subpart F. Under those rules, investment in many different items of U.S. tangible and intangible property are treated as disguised distribution. In proposed regulations issued in October, the I.R.S. announced that U.S. corporations that are U.S. Shareholders of C.F.C.'s are no longer subject to tax on investments in U.S. property made by the C.F.C. Stanley C. Ruchelman explains the new rules and their simple logic – if the C.F.C. were to distribute a hypothetical dividend to a U.S. Shareholder that would benefit from the 100% D.R.D., the taxable investment in U.S. property will be reduced by an amount that is equivalent to the D.R.D. allowed in connection with the hypothetical dividend.

- **How to Handle Dual Residents: The I.R.S. View on Treaty Tie-Breaker Rules.** The first step in advising a foreign individual who is neither a U.S. citizen nor a green card holder on U.S. income tax laws is to determine the person's residence for income tax purposes. But what is to be done when the individual is resident in multiple jurisdictions? A recent LB&I International Practice Unit offers a quick understanding of the tax issues I.R.S. examiners raise when dealing with individuals who are dual residents for tax purposes. Virtually all income tax treaties entered into by the U.S. contain a tiebreaker rule under which the exclusive residence of an individual is determined for purposes of applying the income tax treaty. Fanny Karaman and Beate Erwin explain how these rules are applied. One point to remember is that the tiebreaker test for treaty residence purposes does not affect an individual's obligation to file an F.B.A.R. form.

We hope you enjoy this issue.

- The Editors

ALTA ENERGY AFFIRMS TREATY BENEFITS: A CANADIAN CASE STUDY FOR APPLYING THE M.L.I.

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INTRODUCTION

The Tax Court of Canada in *Alta Energy Luxembourg S.A.R.L. v. The Queen*[1] ("*Alta Energy*") and its interplay with Canada's potential future application of the principal purpose test ("P.P.T.") under the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "Multilateral Instrument" or "M.L.I.") designed by the O.E.C.D., which Canada signed on June 7, 2017.

Alta Energy resulted from an assessment of Alta Energy Luxembourg S.A.R.L. ("Luxco"), a company resident in Luxembourg for the purposes of the double income tax convention concluded between Canada and Luxembourg (the "Canada-Luxembourg Treaty"),[2] following its sale of shares of Alta Energy Partners Canada Ltd. ("Canco") to Chevron Canada Ltd. ("Chevron"), an arm's length party.

It should be noted that a Notice of Appeal was filed with respect to *Alta Energy* with the Federal Court of Appeal on October 1, 2018.

BACKGROUND

In the spring of 2011, Blackstone Group LP and Alta Resources LLC (together, the "Investors") formed Alta Energy Partners, LLC ("USco"), a limited liability company formed pursuant to the laws of Delaware. In June 2011, the Investors incorporated Canco, a wholly owned subsidiary of USco. Canco was granted the right to explore, drill, and extract hydrocarbons from an area in Alberta designated under licenses (the "Licenses") granted by the government of Alberta.

Pursuant to the double income tax convention between Canada and the U.S. (the "Canada-U.S. Treaty"),[3] a sale of Canco by USco would likely have resulted in a capital gain subject to tax in Canada as well as the U.S.; the Investors had been advised that the total investment in Canco was expected to grow between $300 and $400 million in two years.

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1 2018 TCC 152.

2 *Convention Between the Government of Canada and the Government of the Grand Duchy of Luxembourg For the Avoidance of Double Taxation and the prevention of Fiscal Evasion with respect to Taxes on Income and on Capital,* signed on September 10, 1999, as amended by the Protocol signed on May 8, 2012.

3 *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital*, as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

The Investors determined that the decision to have Canco held by USco was a mistake[4] and realized that a restructuring was necessary in order to address current[5] and future adverse income tax consequences.

In December 2011, the Investors corresponded with Luxembourg tax authorities regarding the tax regime that would be applicable should a corporation resident in Luxembourg (*e.g.*, Luxco) dispose of the shares of Canco.[6]

"Canadian income tax is payable on the gain realized from the disposition of Taxable Canadian Property . . . that is not Treaty Protected Property."

In April 2012, the Investors formed Luxco. Luxco was formed in order to hold the Investors' participations in Luxembourg and in foreign companies.[7] Luxco's sole shareholder, *Alta Energy* Canada Partnership, was a partnership established pursuant to the laws of Alberta.

On the same day, USco transferred the shares of Canco to Luxco (the "Transfer"). The Transfer would have resulted in a capital gain in Canada to USco, except that the Canada Revenue Agency (the "C.R.A.") accepted that Canco's shares on the date of the Transfer had a fair market value ("F.M.V.") equal to USco's adjusted cost base in Canco, resulting in zero gain. However, the court noted[8] that the Investors undoubtedly incurred significant legal costs in connection with the establishment of the revised structure.

Canco continued to acquire additional Licenses. In September 2013, Luxco agreed to sell its shares of Canco to Chevron (the "Sale").

Relying on Articles 13(4) and 13(5) of the Canada-Luxembourg Treaty, Luxco did not pay any income tax in Canada with respect to the Sale.

TAX CONSEQUENCES UNDER THE INCOME TAX ACT AND THE CANADA-LUXEMBOURG TREATY

Pursuant to the Income Tax Act (Canada) (the "I.T.A."),[9] Canadian income tax is payable on the gain realized from the disposition of Taxable Canadian Property, as defined in the I.T.A.,[10] that is not Treaty Protected Property, as defined in the I.T.A.[11]

Luxco conceded that the shares of Canco were Taxable Canadian Property at the time of the Sale because the shares of Canco derived more than 50% of their value

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4 *Supra* note 1, para. 19.

5 *E.g.*, anti-deferral rules in Subpart F of the Code.

6 *Supra* note 1, para. 21.

7 *Id.*, para. 22.

8 *Id.*, para. 25.

9 R.S.C., 1985, c.1 (5th Supp.).

10 Subsection 248(1) of the I.T.A. Generally, a share of the capital stock of a corporation (*e.g.*, Canco) is Taxable Canadian Property if, at the time of its disposition or within 60 months prior to that time, more than 50% of the F.M.V. of the share was derived, *inter alia*, directly or indirectly from one or any combination of the following: (i) real or immovable property situated in Canada, (ii) Canadian Resource Properties, (iii) Timber Resource Property (as defined in subsection 13(21) of the I.T.A.), and (iv) options or interests with respect to any of the foregoing.

11 Subsection 248(1) of the I.T.A.

from Canadian Resource Property, as defined in the I.T.A.[12] However, Luxco contended that the shares of Canco were Treaty Protected Property and therefore exempt from tax under the I.T.A.

Treaty Protected Property is defined[13] as follows:

> . . . property any income or gain from the disposition of which by the taxpayer at that time would, because of a tax treaty with another country, be exempt from tax under Part I [of the I.T.A.].

Article 13 of the Canada-Luxembourg Treaty governs, *inter alia*, capital gains realized by a resident of one contracting state (Luxembourg) arising from the disposition of property in the other state (Canada).

Article 13(4) and (5) of the Canada-Luxembourg Treaty states:

> 4. Gains derived by a resident of a Contracting State from the alienation of:
>
> (a) shares (other than shares listed on an approved stock exchange in the other Contracting State) forming part of a substantial interest in the capital stock of a company the value of which shares is derived principally from immovable property situated in that other State; or
>
> (b) an interest in a partnership, trust or estate, the value of which is derived principally from immovable property situated in that other State,
>
> may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" *does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on*; and a substantial interest exists when the resident and persons related thereto own 10 per cent or more of the shares of any class or the capital stock of a company.
>
> 5. Gains from the alienation of any property, other than that referred to in paragraphs 1 to 4[14] shall be taxable only in the Contracting State of which the alienator is a resident. [emphasis added]

The parties agreed that the shares of Canco derived their value principally from immovable property situated in Canada (per Article 13(4)(a) of the Canada-Luxembourg Treaty); at issue was whether the shares of Canco fell into the exemption for immovable property in which the business of the company (*e.g.*, Canco) was carried on (the "Immovable Property Exemption"). If the shares of Canco fall into the Immovable Property Exemption, the Sale should not be subject to tax in Canada pursuant to Article 13(4)(a) of the Canada-Luxembourg Treaty and should only be

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12 Subsection 66(15).

13 Subsection 248(1) of the I.T.A.

14 The parties did not raise arguments regarding Articles 13(1)-13(3) of the Canada-Luxembourg Treaty.

subject to tax in Luxembourg pursuant to Article 13(5) of the Canada-Luxembourg Treaty. In contrast, if Canco were found not to carry on its business through Canadian Resource Properties, the Sale should be subject to tax in Canada pursuant to Article 13(4)(a) of the Canada-Luxembourg Treaty and subsection 2(3) of the I.T.A.

As an alternative, the Minister of National Revenue (the "Minister") raised an argument under Canada's general anti-avoidance rule ("Canada's G.A.A.R.")[15] contending that a misuse or abuse of the I.T.A. and/or the Canada-Luxembourg Treaty resulted from the fact that Luxco, although a resident of Luxembourg for the purposes of the Canada-Luxembourg Treaty,[16] was created and became the owner of the shares of Canco for no purpose other than avoiding Canadian income tax on any gain that Luxco might realize from the Sale.[17]

DISCUSSION AND ANALYSIS

Does the Sale Fit into the Immovable Property Exemption?

As noted above, when a nonresident of Canada disposes of Taxable Canadian Property, Canada asserts the right to tax the nonresident on the gain, unless the property is Treaty Protected Property. The parties in *Alta Energy* agreed that Luxco's shares in Canco constituted Taxable Canadian Property on the basis that they derived more than 50% of their F.M.V. from Canadian Resource Properties;[18] the disagreement was whether the shares constituted Treaty Protected Property.

The court's reasoning began with its determination that Articles 13(1) and 13(5) of the Canada-Luxembourg Treaty assisted in illustrating the purpose of Article 13(4).[19] Article 13(1) of the Canada-Luxembourg Treaty provides that gains derived from the disposition by a party in one jurisdiction (*e.g.*, Luxembourg) of immovable property in another jurisdiction (*e.g.*, Canada) will be subject to tax in the state in which the property was located (*e.g.*, Canada). Article 13(4) of the Canada-Luxembourg Treaty supplements this rule by preventing a taxpayer from simply conducting a share sale, rather than an asset sale, in order to avoid tax in the jurisdiction in which the immovable property is situated.[20]

The court appears to have determined that this rule indicates a general principle that, in concluding the Canada-Luxembourg Treaty, Canada and Luxembourg generally gave up their rights to tax capital gains as an incentive to promote capital inflows, except when the gain was principally derived from immovable property other than immovable property in which a business is carried on.[21] According to the court, Article 13(5) of the Canada-Luxembourg Treaty embodied that principle.[22]

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15 Section 245 of the I.T.A.

16 Article 4.

17 *Supra* note 1, para. 75.

18 *Supra* note 10.

19 *Supra* note 1, paras. 39 and 40.

20 *Id.*, para. 41.

21 *Id.*, paras. 39-41.

22 *Ibid.*

The court also relied heavily on a 1991 position paper (the "Position Paper")[23] authored by an official of the Government of Canada.[24] According to the Position Paper,[25] the C.R.A. received numerous requests for technical interpretations concerning what is meant by "property, other than rental property, in which the business of the company was carried on" ("Excluded Property") in the application of certain double income tax conventions signed by Canada and in the context of resource industries.[26] The Position Paper was written in response to those requests and provides as follows:

> **Positions** . . .
>
> 3. Oil and gas reserves, *mines and royalty interests are Excluded Property if the owner is actively engaged in the exploitation of natural resources and if such assets are actively exploited or kept for future exploitation by such owner,* subject to exceptions resulting to hydrocarbons in the Canada-United Kingdom Convention. [emphasis added][27]

The Position Paper also provides the rationale for its positions.

The court interpreted the comments in Position 3 as setting out two conditions for oil and gas reserves to qualify as Excluded Property: (i) The corporation must be actively engaged in the exploration of the reserve, and (ii) the reserve must be actively exploited or kept for future exploitation by the owner.[28]

The court then discussed the nature of the oil and gas exploitation industry (the "Industry"). Generally, the court described how the Industry requires significant upfront capital investment and a trial and error methodology for finding and exploiting reserves, acknowledging that not every part of a working interest can be exploited at once.[29]

In order to maximize the opportunities for exploiting a reserve, the court determined that Canco, directly and indirectly, purchased multiple Licenses and took steps to "properly delineate the part of the formation that it controlled in order to plan how and when it would drill wells, extract hydrocarbons, and bring the hydrocarbons to the market."[30] Canco was not drilling on all areas for which it had Licenses but chose locations to drill based on their likelihood to benefit the entire operation. The court focused on the fact that Canco was at all times using the best practices of the Industry to develop its reserves.[31]

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23 The authors obtained a copy of the Position Paper from the court. The author of the Position Paper is G. Arsenault; the Position Paper is dated February 28, 1991.

24 *Supra* note 1, para. 42.

25 In the *Background* section on page 1.

26 See also *supra* note 1, para. 44.

27 We note that the Position Paper was published in 1991; it is unknown whether the positions in the Position Paper reflect the current positions of the C.R.A.

28 *Supra* note 1, para. 45.

29 *Id.*, paras. 46-68.

30 *Id.*, para. 65.

31 *Id.*, para. 64.

In arguing that the shares of Canco did not constitute Excluded Property, the Minister took the position that only the properties where the Licenses were being actively used – *i.e.*, where drilling was actually taking place – could constitute Excluded Property. In other words, the Licenses to exploit hydrocarbons located under land being drilled could constitute Excluded Property on the basis that those properties were each a property in which the business of Canco was being carried on; however, Licenses to exploit hydrocarbons located under land that Canco was not drilling would not be Excluded Property, as Canco would not be conducting business on parcels where no drilling was actively taking place.

The court disagreed with this reasoning. The court determined that the Canada-Luxembourg Treaty negotiators "intended for a resource property to qualify as Excluded Property when such property is developed in accordance with the industry's best practices."[32]

In its interpretation of the Canada-Luxembourg Treaty, the court determined that the purpose of the Immovable Property Exemption is to attract foreign direct investments and that it is, therefore, also reasonable to assume that the negotiators of the Canada-Luxembourg Treaty intended for the Immovable Property Exemption to be granted in accordance with Industry practices.[33] This would mean that, although Canco was not drilling on all of the properties for which it had Licenses, so long as Canco obtained the property for use in its exploitation operations in a manner that was in keeping with Industry practices, Canco could be said to be carrying on its business in such properties for the purposes of Article 13(4) of the Canada-Luxembourg Treaty.

"The negotiators of the Canada-Luxembourg Treaty intended for the Immovable Property Exemption to be granted in accordance with Industry practices."

The court further determined[34] that the Minister's interpretation would have been contrary to the terms expressed in the Position Paper, which included in the definition of Excluded Property, assets that are "actively exploited or *being kept for future exploitation*" [emphasis added], provided that the corporation was otherwise carrying on an active business.[35]

Although the Position Paper is not binding law, the court stated that, because it was a stated position from the C.R.A., taxpayers should be able to rely on it.[36]

Since Canco was conducting its business on all of the properties for which it had Licenses, the court determined that such properties constituted Excluded Property, such that the Sale fit within the Immovable Property Exemption and should not be subject to tax in Canada.[37]

Does Canada's G.A.A.R. Apply to the Transactions?

While a full analysis of Canada's G.A.A.R. is outside the scope of this article, generally, section 245 of the I.T.A. can apply to prevent a taxpayer from realizing a tax benefit once a transaction or series of transactions meet three criteria:

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32 *Id.*, para. 64. The court also added, in note 10, "In this regard, I share the opinion expressed in the Position Paper."

33 *Id.*, para. 68.

34 *Id.*, para. 55.

35 *Ibid.*

36 *Id.*, para. 56.

37 *Id.*, para. 69.

- The transaction or series of transactions resulted in a "tax benefit."[38]

- The transaction or series of transactions constituted an "avoidance transaction."[39]

- It cannot reasonably be considered that the transaction or series of transactions would not result directly or indirectly in (i) a misuse of the provisions of the I.T.A., a tax treaty, or similar legislation, or (ii) an abuse having regard to the provisions of the I.T.A., tax treaty, or similar legislation read as a whole.[40]

Luxco agreed that, as a result of the restructuring, there had been a tax benefit and an avoidance transaction but argued that the avoidance transaction was not abusive.[41] The only issue before the court was whether or not there had been a misuse or abuse of a provision of the I.T.A. or the Canada-Luxembourg Treaty.

Pursuant to jurisprudential procedure concerning Canada's G.A.A.R.,[42] the court first looked to the "object, spirit, and purpose" of the I.T.A. and the Canada-Luxembourg Treaty, noting that statutory interpretation under Canada's G.A.A.R. differs from traditional word-based interpretation.[43] The court restated the general application of Canada's G.A.A.R. analysis:[44]

> Whereas, under the modern rule of statutory interpretation the analysis seeks to determine what the meaning of a provision is, under the GAAR, statutory interpretation is used to determine the object, spirit or purpose of the provision.[45] The object, spirit or purpose is the rationale underlying the provision. Transactions may be found abusive of a provision's underlying rationale, even though they comply with the literal, contextual and purposive meaning of the words of the statute.[46]

The court briefly dealt with arguments as to whether the Sale could be a misuse or abuse of provisions of the I.T.A. and determined that it could not:

> It is clear that those provisions[[47]] are not intended to operate in the case where a non-resident realizes a gain from the disposition of the 'treaty protected property' . . . I have concluded that the [shares of Canco] are 'treaty protected property.'[48]

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38 As defined in subsection 245(1) of the I.T.A.

39 As defined in subsection 245(3) of the I.T.A.

40 Subsection 245(4) of the I.T.A.

41 *Supra* note 1, para. 70.

42 See, *e.g.*, *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.

43 *Supra* note 1, para. 71.

44 *Ibid.*

45 *Copthorne Holdings Ltd. v. R.*, 2011 SCC 63 [2011] 3 S.C.R. 721 (S.C.C.), para. 70.

46 *Id.*, para. 109.

47 Sections 38 and 39, subsection 2(3), and para. 115(1)(b) of the I.T.A.

48 *Supra* note 1, para. 74.

Having determined that the shares of Canco were Treaty Protected Property, which should be exempt from tax under the I.T.A., the court stated that all of the provisions of the I.T.A. operated in the manner intended by Canadian Parliament – *i.e.*, exempting Treaty Protected Property from Canadian tax. Therefore, the Sale should not have resulted in any misuse or abuse of the I.T.A.

The remaining question was whether there had been a misuse or abuse of the Canada-Luxembourg Treaty.

The Minister argued that the misuse or abuse resulted from the fact that Luxco, although a resident of Luxembourg for the purposes of Article 4 of the Canada-Luxembourg Treaty, was created and became the owner of the shares of Canco for no purpose other than avoiding Canadian income tax on the gain realized on the Sale. The Minister also noted that Luxco paid no tax in Luxembourg with respect to the Sale.[49]

The court stated[50] that the avoidance of "foreign tax" is irrelevant and further stated that the term "tax benefit" does not include a tax benefit under foreign law.[51]

The court went on to state that, under an analysis of Canada's G.A.A.R., the court was required to identify the rationale underlying the particular provisions of the Canada-Luxembourg Treaty, and not "a vague policy supporting a general approach to the interpretation of the [Canada-Luxembourg Treaty] as a whole."[52]

Similar to the court's analysis with respect to Canada's G.A.A.R. concerning the I.T.A., the court generally found that the provisions of the Canada-Luxembourg Treaty were applied by Luxco in the manner in which they were intended.

The court made several references to the particularities of some of Canada's other tax treaties. The court noted that the Canada-Luxembourg Treaty does not contain a limitation on benefits provision[53] ("L.O.B. Provision") that might deny access to treaty benefits[54] and further noted that the Canada-Luxembourg Treaty includes a

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49 *Supra* note 1, para. 75.

50 *Id.*, note 14.

51 The court also stated at para. 85:

> When the [Canada-Luxembourg Treaty] was negotiated, the Canadian treaty negotiators were aware of the fact that Luxembourg allowed its resident to avoid Luxembourg income tax on gains arising from the sale of shares of foreign corporations in broad circumstances. In this light, if Canada wished to curtail the benefits of the [Canada-Luxembourg Treaty] to potential situations of double taxation, Canada could have insisted that the exemption provided for under Article 13(5) [of the Canada-Luxembourg Treaty] be made available only in the circumstance where the capital gain was otherwise taxable in Luxembourg. Canada and Luxembourg did not choose this option. It is certainly not the role of the court to disturb their bargain in this regard

52 *Supra* note 1, para. 77.

53 As can be found in Article XXIX A of the Canada-U.S. Treaty.

54 *Supra* note 1, para. 80.

specific carve-out for immovable property in which the business of a company is carried on (*i.e.*, the Immovable Property Exemption).

The court stated that it is important to consider the O.E.C.D.'s Model Tax Convention on Income and Capital[55] and its commentaries (the "O.E.C.D. Model Treaty") because the O.E.C.D. Model Treaty often serves as a baseline in Canadian treaty negotiations.[56] The court noted that the Immovable Property Exemption is not included in the O.E.C.D. Model Treaty and, as a result, the inclusion of the Immovable Property Exemption in the Canada-Luxembourg Treaty is significant because it demonstrates a specific intention of one or both of the parties to the Canada-Luxembourg Treaty to diverge from the usual approach.[57]

> The OECD Model Treaty does not include a carve-out for immovable property in which the business of the company is carried on. Departure from the model tax treaty may be significant as it demonstrates the intent of one, or both, parties to diverge from the general approach. When there is no common agreement on a specific point at the start of the negotiations, a divergence may be the result of a bargain struck by the parties. In the instant case, it is apparent that the parties intended to depart from the [O.E.C.D. Model Treaty]. This departure involved carving out from the definition of immovable property properties where economic activities were carried on.
>
> Parties to a tax treaty are presumed to know the other country's tax system when they negotiate a tax treaty; they are presumed to know the tax consequences of a tax treaty when they negotiate amendments to that treaty. The OECD commentaries highlight that some states—like Luxembourg—generally do not tax capital gains: OECD commentary on Article 13, 28.12. It is then the responsibility of the state that does tax capital gains to prevent a double exemption if it wishes to do so.[58]

The court went on to say that if Canada wanted to prevent Luxembourg residents from escaping taxation on transactions that are not taxed in Luxembourg, it could have considered this when negotiating the Canada-Luxembourg Treaty, but did not. It was therefore "certainly not the role of the court to disturb their bargain in this regard."[59]

The Minister also raised the argument that benefits for Luxco under the Canada-Luxembourg Treaty should be denied because Luxco's actions constituted "treaty shopping," which should constitute an abuse of the Canada-Luxembourg Treaty.[60] The term "treaty shopping" is not defined in the I.T.A. nor in any double income tax convention signed by Canada. The O.E.C.D. Glossary of Tax Terms defines "treaty shopping" as:

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55 Dated December 18, 2017.

56 *Supra* note 1, para. 82.

57 *Id.*, para. 83.

58 *Id.*, paras. 83 and 84.

59 *Id.*, para. 85. See also *supra* note 50.

60 *Id.*, para. 92.

> **TREATY SHOPPING** – An analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty. The term is normally applied to a situation where a person not resident of either the treaty countries establishes an entity in one of the treaty countries in order to obtain treaty benefits.

Again, the court referred to other tax treaties to which Canada is a party and compared this issue to the L.O.B. Provision in the Canada-U.S. Treaty.[61] The court noted that the U.S. had developed comprehensive anti-treaty shopping rules that demonstrate how parties could impose conditions other than residence in order to curtail treaty shopping.[62]

Instead, the court stated[63] that the O.E.C.D. Model Treaty,[64] published at the time of the signing of the Canada-Luxembourg Treaty, as well as the Canada-Luxembourg Treaty, only contain "a very narrow" anti-abuse or treaty shopping rule in Articles 10, 11, and 12, based on beneficial ownership and impacting only dividends, interest, and royalties (respectively).[65]

The court did note, however, that Canada's Department of Finance has been in the process of reconsidering the country's bilateral approach to treaty shopping and, in 2013, released a consultation paper[66] (the "Consultation Paper") requesting comments from taxpayers. In summary, the Consultation Paper proposed two approaches: (i) the continuation of the bilateral (treaty) approach or (ii) a new approach that would lead to the enactment of a domestic anti-treaty shopping rule that, potentially, would override all of Canada's tax treaties (the "Domestic Approach"). The court commented that Finance favored the Domestic Approach since such domestic legislation could be enacted more swiftly than international treaties.[67] Finance indeed had previously confirmed this by announcing in the 2014 Federal Budget[68] that it would proceed unilaterally under the Domestic Approach and provided proposed anti-treaty-shopping rules (the "Proposed Rules"). The Proposed Rules have not been enacted through Canadian legislation.

The court stated that the Minister sought to achieve the same result using Canada's G.A.A.R. as should be achieved under the Proposed Rules, *i.e.*, to use Canada's

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61 The court referenced Article XXIX-B of the Canada-U.S. Treaty (being the article relating to Taxes Imposed by Reason of Death); however, we respectfully believe that the court meant to reference Article XXIX-A of the Canada U.S. Treaty.

62 *Supra* note 1, para. 94.

63 *Id.*, para. 93.

64 O.E.C.D. Model Tax Convention on Income and on Capital, June 1998.

65 In *Alta Energy* (*supra* note 1), the court states (in para. 93) that the certain types of income include dividends, rents, and royalties and not dividends, interest, and royalties; however, the court does make note of Article 11 of the Canada-Luxembourg Treaty, which governs interest.

66 Consultation Paper on Treaty Shopping – The Problem and Possible Solutions, August 12, 2013.

67 *Supra* note 1, para. 95.

68 Budget 2014, Annex 2 – Tax Measures: Supplementary Information, Consultation on Tax Planning by Multinational Enterprises.

G.A.A.R. in order to "deal with what Finance now believes is an unintended gap in the [Canada-Luxembourg Treaty]."[69] Relying on prior case law,[70] the court ruled that the Minister could not rely on Canada's G.A.A.R. to deal with an unintended gap in the Canada-Luxembourg Treaty[71] and generally supported the Federal Court of Appeal's view[72] that a taxpayer cannot misuse or abuse a treaty by claiming an exemption provided by the treaty.[73]

It should be noted that the court also quickly rejected an argument by the Minister that Luxco should be denied benefits under the Canada-Luxembourg Treaty because it was a "conduit."[74] The court determined that Luxco was the beneficial owner of the shares of Canco and stated that the Minister's argument that Luxco was acting as a conduit appeared to be inconsistent with the Minister's acceptance of Luxco as the "beneficial owner" of the shares of Canco, based on the fact that Luxco was the lawful recipient of the proceeds from the Sale.

Having determined that the Sale fit within the Immovable Property Exemption and that there was no misuse or abuse under Canada's G.A.A.R. or the Canada-Luxembourg Treaty, the court ruled in favor of Luxco.

As previously noted, the Minister filed a Notice of Appeal with respect to *Alta Energy* with the Federal Court of Appeal on October 1, 2018.

How Would the Multilateral Instrument and the P.P.T. Impact the Transactions?

Canada and Luxembourg have each signed the M.L.I., although, as of the time of writing, neither has deposited its instrument of ratification, acceptance, or approval with the O.E.C.D.[75] The Parliament of Canada had its first reading of Bill C-82 – An Act to Implement a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Bill") – on June 20, 2018, in the House of Commons of Canada. The Bill had its second readings in the House of Commons on September 28, 2018, and October 15, 2018, and, as of the time of writing, has been referred to the Standing Committee on Finance.

Article 7(1) of the M.L.I. provides a rule, often referred to as the P.P.T., designed to prevent perceived tax treaty abuses. Article 7(1) of the M.L.I. states:

> 1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to

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69 *Supra* note 1, para. 98.

70 *Garron Family Trust (Trustee of) v. R.*, 2009 TCC 450, and *Garron Family Trust (Trustee of) v. R.*, 2010 FCA 309.

71 *Supra* note 1, para. 98.

72 In *Garron Family Trust (Trustee of) v. R.*, 2010 FCA 309.

73 *Supra* note 1, paras. 99-100.

74 *Id.*, paras. 86-89.

75 A requirement for the M.L.I. to come into effect with respect to the Canada-Luxembourg Treaty. For additional information on parties to the M.L.I. and implementation status, see Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

> conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

"If the benefit is in accordance with the 'object and purpose' of the relevant provisions of a treaty, Article 7 should not apply to undo the tax benefit."

The court did not address the application of the M.L.I. or the P.P.T. in *Alta Energy*; however, since the transactions at issue occurred in 2013, it is unlikely that the M.L.I. would have been applicable.

There are similarities between Article 7(1) of the M.L.I. and Canada's G.A.A.R. For example, pursuant to the P.P.T., one must consider whether there has been an arrangement or transaction that resulted directly or indirectly in a benefit. Recall that, pursuant to Canada's G.A.A.R., there must be a transaction or series of transactions that resulted in a tax benefit.

In *Alta Energy*, Luxco essentially admitted that the transfer of the shares of Canco by USco to Luxco was not arranged primarily for a *bona fide* purpose other than to obtain a tax benefit.[76] As a result, Luxco may have also failed the first part of the P.P.T.

However, the P.P.T. also includes a saving provision: If the benefit is in accordance with the "object and purpose" of the relevant provisions of a treaty, Article 7 should not apply to undo the tax benefit, notwithstanding the impugned transaction's principal purpose.

This language is similar to the third prong of Canada's G.A.A.R., which asks courts to determine the object, spirit, and purpose of the relevant provisions of the applicable legislation or treaty and only apply Canada's G.A.A.R. when there has been a misuse or abuse of such provisions.

In determining that the rationale behind the Immovable Property Exemption in Article 13(4) of the Canada-Luxembourg Treaty was "to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business,"[77] the court resolved that there was no misuse or abuse of the relevant provisions of the Canada-Luxembourg Treaty. Therefore, Canada's G.A.A.R. did not apply to undo the tax benefit provided by the Canada-Luxembourg Treaty.

Had the court been required to consider Article 7(1) of the M.L.I. in *Alta Energy*, it seems likely that the result would have been the same. If the benefit that the transactions provided was only to exempt Luxco, a resident of Luxembourg, from tax on an (indirect) disposition of immovable property used in an active business, then this should be in accordance with their object and purpose, under the court's understanding of the relevant provisions of the Canada-Luxembourg Treaty.

The so-called misuse or abuse language in Canada's G.A.A.R.[78] implies a more serious threshold than one might expect to be imposed under the M.L.I. Practically

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76 *Supra* note 1, para. 70.

77 *Id.*, para. 100.

78 Subsection 245(4) of the I.T.A.

though, Canadian courts have generally conducted the misuse or abuse analysis by determining whether the avoidance transaction at issue frustrated the object, spirit, or purpose of the provisions at play, and applying Canada's G.A.A.R. in situations where transactions have done so. This analysis may be similar to what courts will be asked to do when considering the P.P.T. under the M.L.I.

CONCLUSION

The court's decision in *Alta Energy* was based on the court's understanding of Articles 13(4) and 13(5) of the Canada-Luxembourg Treaty. While the court did not expressly consider the M.L.I., its reasoning is informative with respect to how a future court might work its way through a P.P.T. analysis. As the analyses under Canada's G.A.A.R. and the M.L.I.'s P.P.T. appear to be quite similar, it may be helpful to look to prior Canadian decisions on Canada's G.A.A.R. for discussions regarding how future courts, Canadian and otherwise, may interpret and apply the P.P.T. under the M.L.I.

REVISED SWISS CORPORATE TAX REFORM WILL KEEP SWITZERLAND A TOP CORPORATE LOCATION

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INTRODUCTION

This article focuses on the latest developments in the long-awaited Swiss corporate tax reform. In order to give an overview of the reform in its latest iteration, this article offers historical background, presents the key measures of the new reform, assesses the current outlook for the project, and summarizes its results for corporations.

BACKGROUND ON THE REVISED TAX REFORM

Swiss Corporate Tax Reforms I and II

In the first iteration of its corporate tax overhaul, the Swiss Corporate Tax Reform 1997 ("C.T.R. I"), Switzerland introduced various measures to improve its reputation as an attractive jurisdiction based on corporate tax rules. Included in the C.T.R. I were measures such as a comprehensive exemption for participation income and participation profits of holding, mixed, and principal companies and finance branches ("Status Privilege"). These measures resulted in a substantial or complete exemption from income tax on the cantonal and communal levels for status privilege companies.

After the implementation of C.T.R. I, Switzerland experienced an influx of holding companies and companies qualifying for Status Privilege, which prompted a new corporate tax reform in 2007 ("C.T.R. II"). C.T.R. II was intended to improve upon C.T.R. I and to further establish Switzerland as a holding company location. Notably, C.T.R. II led to a partial tax exemption for qualifying participations in order to prevent double taxation on dividends for substantial shareholders and to the implementation of the capital contribution principle.

International Pressure on the Swiss Corporate Tax System

Simultaneously, Switzerland's corporate tax law became the focus of attention from the O.E.C.D., the G-20, and the E.U. The main criticism of these international institutions was that Switzerland enabled multinational companies with Status Privilege to shift profits globally without being taxed at the base where the income was obtained. At the peak of the tax dispute, the O.E.C.D. put Switzerland on a "grey list" of countries that were not compliant with commonly agreed-upon O.E.C.D. standards

Rejection of Swiss Corporate Tax Reform III

In connection with this international pressure and Switzerland's desire to recover its position as a fair and attractive tax location, the Federal Council and the Federal Assembly developed a new corporate tax reform that was introduced initially in 2015 ("C.T.R. III"). The initial version of C.T.R. III was compliant with international tax

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standards, including the O.E.C.D.'s B.E.P.S. Project, and contained, among other things, the required abolition of the Status Privilege. At the same time, it would have enabled Switzerland to be competitive from an international tax perspective.

Nevertheless, Swiss left-wing parties did not agree with C.T.R. III and launched a referendum to prevent adoption. Switzerland has a long history of placing certain legislative proposals to a vote by all citizens as a means of enhancing participatory democracy. Ultimately, Swiss voters rejected C.T.R. III in a referendum held in February 2017.

"One of the most important actions of T.R.A.F. is the abolition of status privilege on a cantonal level."

This allowed Status Privilege to remain in force, notwithstanding international pressure. For companies that were active on a cross-border basis, this situation lead to legal and planning uncertainties.

T.P. 17 and T.R.A.F.

After the rejection of C.T.R. III, the Federal Council released a revised corporate tax reform called Tax Proposal 17 ("T.P. 17") on March 21, 2018. The majority of the measures in T.P. 17 corresponded to measures in C.T.R. III but were more balanced in order to reach a political consensus. Nonetheless, before T.P. 17 reached a vote in the Federal Assembly, it was unclear whether the parties would reach an agreement on the matter.

For this reason, a new CHF 2 billion per year subsidy for the Federal Social Security Scheme ("A.H.V.") was added to the T.P. 17 proposal as a form of socio-political compensation. With this addition, the new corporate tax reform, now called the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F."), was adopted with a clear majority by the Swiss Federal National Assembly on September 28, 2018.

The first measures of T.R.A.F. could enter into force in 2019 if no referendum is held challenging its enactment. Some small parties have already announced that they will call for a popular referendum against T.R.A.F. In this case, T.R.A.F. would most likely be put to the people's vote in May 2019. Accordingly, implementation of T.R.A.F. would be delayed by at least a year.

T.R.A.F. – KEY MEASURES

Revocation of Status Privilege, Disclosure of Hidden Reserves, and Capital Tax Relief

Revocation of Status Privilege

One of the most important actions of T.R.A.F. is the abolition of Status Privilege on a cantonal level so that the Swiss tax jurisdiction is again compliant with international tax standards (*e.g.*, the B.E.P.S. Project).

Disclosure of Hidden Reserves for Status Privilege Companies

As a result, status privilege companies remaining in Switzerland will be forced to transition from privileged to ordinary taxation. In such a case, a so-called two-rate system is applicable. Profits relating to hidden reserves obtained under Status Privilege will be subject to a five-year limited special rate. Cantons will be free to determine this special tax rate. The disclosure of hidden reserves ensures a competitive income tax burden and is intended to encourage current status privilege companies to remain in Switzerland.

Step-up of Hidden Reserves for Companies Relocating to Switzerland

Companies relocating to Switzerland can disclose foreign hidden reserves to the Swiss tax authorities. These companies will benefit from a step-up in basis and can amortize the tax-free disclosed hidden reserves annually at an applied rate, thereby reducing taxable income during the amortization period. If these companies later relocate from Switzerland to a foreign jurisdiction, an exit tax will be due on the hidden reserves (as is already the case under preexisting law).

Capital Tax Relief

Another measure to mitigate the future tax burden on status privilege companies is capital tax relief. As such companies now benefit from a low capital tax rate, the cantons will in the future be allowed to lower the taxable capital on patents (and similar rights), qualifying participations, and intra-group loans to maintain their international corporate tax attractiveness.

PATENT BOX AND DEDUCTIONS FOR RESEARCH AND DEVELOPMENT ACTIVITIES

Patent Box

The Patent Box regime is another key measure of T.R.A.F. Net profits from patents and similar rights such as supplementary protection certificates and varieties of plant rights are to be taxed in a metaphorical box in which up to 90% of the cantonal-level tax can be eliminated. To be compliant with the modified nexus approach developed by the O.E.C.D., the Patent Box is applicable only if the corresponding tax-reduced research and development ("R&D") expenditures have already been recaptured and taxed.

Net profits from patents and similar rights are calculated according to the so-called residual-method. The starting point for this method is the overall profit of the product associated with the patent or the overall profit of the company. All profits that are not related to the patent itself are deducted from the overall profit and subject to ordinary taxation. The remaining net profit will be taxed in the Patent Box. The residual-method is very similar to the calculation used for the U.K.'s Patent Box regime.

The Patent Box regime provides benefits for cantonal tax only. All cantons must adopt the regime.

DEDUCTIONS OF R&D ACTIVITIES

In addition to the Patent Box, T.R.A.F. will authorize cantons to introduce an R&D Super-Deduction of up to an additional 50% of business-related costs for R&D activities undertaken in Switzerland. The term R&D activities was outlined very broadly when introduced and is aligned with Article 2 of the Swiss innovation law ("F.I.F.G.") as well as with common standards determined by the O.E.C.D. Basic research, scientific application, and knowledge-based R&D will all be deductible.

The R&D Super-Deduction will be calculated by adding 135% of labor costs plus 80% of invoiced third-party R&D costs to the general R&D costs. The total amount will then be multiplied by a maximum factor of 1.5, resulting in the deductible R&D costs. The invoiced third-party R&D costs must be performed in Switzerland.

RELIEF RESTRICTION

T.R.A.F. includes a restriction to prevent excessive deductions, which could erode the cantons' tax base. Hence, the aggregate tax relief based on the Patent Box, the R&D Super-Deduction, and deductions for self-financing cannot exceed 70% of the taxable profit. The 70% relief restriction also includes depreciation costs associated with a cantonal Status Privilege.

Increased Dividend Taxation and Adjustments to the Capital Contribution Principle

Increased Dividend Taxation

T.R.A.F. will increase the partial tax exemption for dividend income of individuals from qualifying participations introduced by C.T.R. II at the Federal level from 50% (for business investments) or 60% (for private investments) to a standard rate of 70%. At the cantonal level, the relief method will be harmonized and a compulsory tax rate of at least 50% will be implemented. The cantons will have the discretion to set the actual rate, provided that it is at least 50% of the standard rate.

Adjustments of the Capital Contribution Principle

T.R.A.F. will apply a repayment restriction on the capital contribution principle introduced by C.T.R. II for companies listed on the SIX Swiss Exchange. Those listed corporations will be entitled to distribute tax-exempt capital contribution reserves only if they simultaneously pay ordinarily-taxed dividends of at least the same amount. Intra-group dividends are not affected by this adjustment. Moreover, the same rules will be applied to the issue of bonus shares and nominal value increases from capital contribution reserves.

Extension of the Lump-Sum Foreign Tax Credit for Permanent Establishments

In order to prevent double taxation, Swiss permanent establishments of foreign companies will be entitled to claim relief for withholding taxes on income from third countries. The amount claimed will be set at a flat rate notwithstanding the actual withholding tax imposed.

Additional Measures

High-tax cantons (*e.g.*, Zurich, Geneva, and Berne) will have the opportunity to implement a notional interest deduction ("N.I.D.") on excess capital. So far, only the canton of Zurich would meet the requirements for introducing the N.I.D.

With respect to private restructurings, the scope of future tax-free capital gains or repayments of contributed reserves associated with share transfers to wholly controlled holding companies will be limited.

The cantons' share of the Federal direct tax revenue will be raised from 17% to

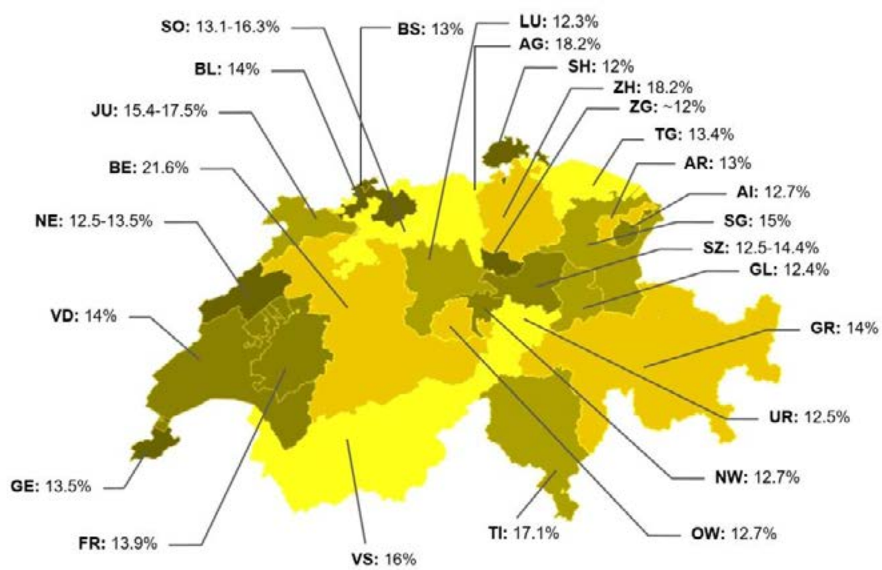
21.2%. In return, the cantons are obliged to consider the needs of cities and communes in connection with the increase of their share.

Finally, and as mentioned above, the Federation will be obligated to pay a higher share of the A.H.V. since it benefits from T.R.A.F. It is expected that over CHF 2.0 billion per year will be raised for financing the A.H.V.

“It is expected that the majority of the Swiss cantons will provide tax rates on pre-tax income between 12% and 18%.”

REDUCED CANTONAL TAX

Although not directly covered by T.R.A.F., another key part of the planned tax reform is that the cantons will also generally reduce their cantonal profit tax rates. This will enable Switzerland to remain attractive to former status privilege companies as well as companies planning to relocate to Switzerland or incorporate in Switzerland. The above-mentioned increase of the canton’s share of the Federal direct tax enables the cantons to further reduce their tax rates. Based on official announcements made by the cantonal governments, it is expected that the majority of the Swiss cantons will provide tax rates on pre-tax income between 12% and 18% including (direct Federal taxes). The map below illustrates the reduced profit tax rates anticipated in each canton:



OUTLOOK FOR CORPORATIONS

T.R.A.F. is intended to achieve several goals for Switzerland:

- It restores legal and planning certainty for Swiss companies that operate on a cross-border basis.
- It reestablishes the reputation of Switzerland as a fair and attractive tax location in a way that is consistent with B.E.P.S. and the demands of the E.U.
- With the abolition of Status Privilege, T.R.A.F. ensures that all companies in Switzerland will be taxed at the same rate, with the exception of those eligible for the Patent Box regime and the R&D Super-Deduction.

Switzerland intends to continue an active ruling practice to provide certainty as to Swiss tax imposed on certain cross-border transactions. This will allow corporations to request an advance ruling from the competent tax administration on the tax treatment of a contemplated transaction. If the tax authorities approve the ruling, the tax treatment is binding, provided the taxpayer strictly follows the fact pattern on which the ruling is based. Note that a tax ruling cannot result in an obvious deviation from clear tax rules. In addition, it is not a binding contract. Therefore, if a new law is enacted that mandates a different result, the ruling will no longer bind the competent tax administration.

Nonetheless, the ruling practice will enable customized tax solutions based on best practices and promote a positive relationship between taxpayers and tax authorities.

THE U.K. DIGITAL SALES TAX – IT COULD BE YOU

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INTRODUCTION

On November 7, 2018, the U.K. government confirmed that it will proceed with the introduction of a digital services tax ("D.S.T.") on large businesses from April 2020. The government concluded that certain business models derive huge value from the participation of U.K. users, which is largely untaxed.

A digital service or product provider outside the U.K. might think that it would not be covered by the tax. Unfortunately, this view would not be correct as – like the G.D.P.R. – the tax is based on the user's jurisdiction and has a global reach.

D.S.T. will charge 2% tax on any revenues that can be "linked" to U.K. users, regardless of where the provider is located and irrespective of whether the business has a physical presence in the U.K.

Note that this is a tax on revenue, not profit, which means the U.K. government takes the view that it can ignore obligations under income tax treaties.

To fall within the D.S.T., a large non-U.K. digital service or product provider need only have U.K. user-related revenues from business activities in one or more key areas: search engines, social media platforms, and online marketplaces.

Unknown at this time is how H.M.R.C. will define the revenues to which the tax will apply. Notwithstanding a 53-page consultation document, H.M.R.C. has not identified the actual hallmarks of tax jurisdiction. The overarching message of the consultation is that, although it is all very difficult, businesses will know if they are supposed to be within the scope of the tax or not and will self-assess their liability accordingly. If a business does not reach the conclusion that H.M.R.C. wants, it can expect a "just and reasonable" recalculation of the tax due.

Regarding the tricky matter of how revenue is linked to user participation, no clear guidance has been given in the consultation document, and many in the market have questioned how a decent definition can even be formulated. The tax is chargeable on revenues generated from defined activities that are linked to the participation of a U.K. user. But, what does that mean?

It is clear that the proposed approach to defining the participation of a U.K. user is incredibly broad – it covers not just advertising revenue from advertisements aimed at U.K. users but pretty much anything involving a U.K. user, even a click on a page by accident.

It comes as a surprise that H.M.R.C. expects large businesses to simply know the accurate location of people clicking on their pages. The task should not be underestimated. There are entire companies dedicated to writing software that determines and tracks where users are located. Moreover, in a world where data protection and data misuse are hot topics, these practices have come under public scrutiny.

DETERMINING COVERAGE UNDER THE THREE TARGETED AREAS

Consultation is ongoing, and in terms of scope, there is no pro*per se*nse yet of where the boundaries will lie.

The definition of activities relating to online marketplaces and search engines are relatively narrow and more or less as expected.

However, the definition of a social media platform is much wider. It covers anything from typical social networks to blogging, review, and discussion platforms. It may even extend to online gaming.

> ***"Although it is all very difficult, businesses will know if they are supposed to be within the scope of the tax or not and will self-assess their liability accordingly."***

D.S.T. is explicitly <u>not</u> a tax on

- online sales of own goods,
- online advertising,
- data collection,
- financial and payment services,
- the provision of online content,
- sales of software or hardware, or
- television or broadcasting services.

Additional exemptions may emerge as the public consultation continues on the proposals.

£500 MILLION THRESHOLD

To fall within the ambit of the tax, a business must generate revenues from the three key areas of at least £500 million globally. Smaller players will not be caught until they start to play in the big leagues. This is problematic since rapidly growing businesses are caught as soon as they pass the threshold, and while the first £25 million of relevant U.K. revenues are exempt, imposing the tax is anti-competitive towards smaller players trying to compete with the global giants.

Particularly problematic is how a business is supposed to isolate in-scope activities when various activities are undertaken. A tax compliance nightmare can be expected even if a company is not, in the end, within the rules. Especially troubled will be those businesses that only have a small proportion of revenue generated from the activities in question but have to spend significant time and fees working out whether D.S.T. should be charged, at all.

There is a proposed safe harbor, but it will entail a costly compliance exercise. The idea is sensible. A company runs an alternative D.S.T. calculation if it has a very low profit margin or is loss making. However, the formula will be difficult to apply in practice, as it first relies on a capability to identify the U.K. profit margin within an international business and then forces the company to apply a whole subset of tax assumptions – varying that margin around what costs are allowed and how overheads are split and excluding exceptional items.

The tax is meant to be temporary, and the U.K. government has promised a formal review in 2025 that would repeal the D.S.T. if an "appropriate international solution" is in place. However, a comprehensive global solution does not look likely to happen anytime soon – the O.E.C.D. must get its Member States to agree. The O.E.C.D. is not making any headway at reaching a consensus and looks unlikely to do so by 2020.

"The U.K. is the first European country to introduce unilateral measures, but it probably will not be the last."

The U.K. is the first European country to introduce unilateral measures, but it probably will not be the last – France and Italy are also pushing for action. At the same time, the European Commission is proposing its own version for the E.U. While adoption of the E.U. approach has been stalled by E.U. politics, with Member States arguing about its terms, an E.U.-wide digital tax is on the horizon, and no one would be surprised to see it adopted in the near term.

CONCLUSION

A digital tax with global reach has been announced in the U.K. It is one of many such taxes proposed in Europe. How the U.K. tax will work in practice is anyone's guess. One certainty at this time is that the cost of demonstrating whether a company is or is not covered will be expensive. If covered, the cost of demonstrating the boundaries of U.K. user-related revenue may be even more costly.

A DEEP DIVE INTO G.I.L.T.I. GUIDANCE

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INTRODUCTION

The 2017 Tax Cuts and Jobs Act ("T.C.J.A.") introduced a new anti-abuse tax regime applicable to controlled foreign corporations ("C.F.C.'s"). The Treasury Department and the I.R.S. introduced Proposed Treasury Regulations on September 13, 2018, ("Proposed Regulations") that provide guidance on calculating global intangible low-taxed income ("G.I.L.T.I."). For an introduction to the G.I.L.T.I. regime, see "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?" in *Insights*.

At one level, the G.I.L.T.I. regime is designed to decrease the incentive for a U.S.-based multinational group to shift corporate profits to controlled subsidiaries based in low-tax jurisdictions. This treatment is particularly important because the T.C.J.A. has modified U.S. tax law to provide a dividends received deduction ("D.R.D.") for dividends received from foreign subsidiaries. Without G.I.L.T.I., a U.S.-based group could erode its U.S. tax base by shifting profit-making activities to its C.F.C.'s that could generate low-tax profits abroad and distribute them to the U.S. parent on a tax-free basis under the D.R.D.

At another level, the G.I.L.T.I. regime reflects a shift in U.S. tax policy regarding international operations. Prior to the T.C.J.A., U.S. tax policy was nominally one of global taxation, but as news articles relating to the largest of U.S. multinational companies indicated, it was effectively a territorial tax system. With a large enough budget, U.S. rules such as those embodied in Subpart F and Code §367(a) and (d) could be gamed so that U.S. tax jurisdiction was limited to income from U.S. operations. With the enactment of the T.C.J.A., the U.S. tax system nominally became a modified territorial tax system. However, the effect of provisions such as the Transition Tax, G.I.L.T.I., and F.D.I.I. is that the U.S. effectively adopted a global tax system with several effective rates. The rates are (i) 8% or 15.5% for transition tax, (ii) 21% for income from domestic operations and international operations caught by Subpart F, and (iii) 13.125% under F.D.I.I. for U.S. operations that service a foreign market and under G.I.L.T.I. for international operations that do not generate immediate tax under Subpart F (once the 80% foreign tax credit on G.I.L.T.I. is factored into the computation).

COMPUTATIONAL CAVEAT

While similarities exist as to the purpose of the G.I.L.T.I. regime and Subpart F Income – each provides for current taxation of certain income of a C.F.C. – certain fundamental differences exist in the way income is included in the tax return of a U.S. Shareholder.

Subpart F Income is determined at the level of each C.F.C. Once it is determined, a U.S. Shareholder of that C.F.C. includes in gross income its *pro rata* share. In this way, the amount of the U.S. Shareholder's inclusion with respect to one C.F.C. is not taken into account in determining that U.S. Shareholder's inclusion with respect to another C.F.C. Stated somewhat differently, a silo exists between each U.S. Shareholder and each separate C.F.C. that is owned. If multiple C.F.C.'s are owned, multiple silos exist.

"No matter how many C.F.C.'s exist, only one single aggregate Tested Income amount is computed."

In comparison, when a U.S. Shareholder computes its income inclusion under the G.I.L.T.I. regime, it aggregates and then nets or multiplies its *pro rata* share of all items into a single shareholder level amount. Consequently, no matter how many C.F.C.'s exist, only one single aggregate Tested Income amount is computed. That amount is reduced by aggregate Tested Loss of all C.F.C.'s reporting losses. The result is only one net Tested Income for the C.F.C.'s and only one aggregate qualified business asset investment ("Q.B.A.I.") that is multiplied by 10% to arrive at only one single deemed tangible income return ("D.T.I.R."). A U.S. Shareholder's G.I.L.T.I. inclusion amount for a taxable year is calculated by subtracting only one aggregate shareholder level amount from another. The U.S. Shareholder's net D.T.I.R. is the excess of the D.T.I.R. over certain interest expense. Finally, the G.I.L.T.I. inclusion amount is the excess of the net C.F.C. Tested Income over its net D.T.I.R. Because there is only one set of computations no matter how many C.F.C.'s are owned by a U.S. Shareholder, an inclusion of G.I.L.T.I. will occur.

GENERAL RULES AND DEFINITIONS

The Proposed Regulations under Prop. Treas. Reg. §1.951A-1 provide general operating rules and definitions:

- Prop. Treas. Reg. §1.951A-1(c)(3) defines D.T.I.R., which is computed at the U.S. Shareholder level based on Q.B.A.I. held by the C.F.C.'s of the shareholder and reduces the shareholder's net C.F.C. Tested Income for purposes of determining the G.I.L.T.I inclusion amount. The Proposed Regulations clarify that a Tested Loss C.F.C. is treated as not having specified tangible property. As a result, tangible property of a Tested Loss C.F.C. is not taken into account in calculating a U.S. Shareholder's aggregate *pro rata* share of Q.B.A.I., its D.T.I.R., or its net D.T.I.R.
- As prescribed by the Code, the Proposed Regulations incorporate the *pro rata* share rules of Subpart F, with modifications to account for the differences between Subpart F Income and the components of G.I.L.T.I. (specifically, Tested Income, Tested Loss, and Q.B.A.I.):
    - The *pro rata* share of Tested Loss and Q.B.A.I. of a preferred shareholder must be computed (discussed below).
    - Tested Income must be allocated among U.S. Shareholders of a C.F.C., so that a C.F.C. having more than one U.S. Shareholder must allocate Tested Income to each U.S. Shareholder's in the same manner as it allocates Subpart F Income to each U.S. Shareholder under Code §951(a)(2) and Prop. Treas. Reg. §1.951-1(b) and (e). In other words, it is based on the relative amount that would be received by

each U.S. Shareholder in a year-end hypothetical distribution of all the C.F.C.'s current year earnings.[1]

- ○ Q.B.A.I. deemed distributed to the U.S. Shareholder in the hypothetical distribution generally must be proportionate to the amount of the C.F.C.'s Tested Income distributed in the hypothetical distribution to the U.S. Shareholder.[2]

- ○ Tested Income between holders of preferred shares and common shares must also be allocated when, for G.I.L.T.I. purposes, a C.F.C. has a positive return on Q.B.A.I. but a loss from operations. Where a C.F.C.'s Q.B.A.I. exceeds its Tested Income by a factor of ten or more, so that the amount of Q.B.A.I. allocated to preferred stock exceeds ten times the Tested Income allocated to the preferred stock under the general proportionate allocation rule, the excess amount of Q.B.A.I. must be allocated solely to the C.F.C.'s common stock.[3] This rule is meant to ensure that the notional return associated with the C.F.C.'s Q.B.A.I. generally flows to the shareholders in a manner consistent with their economic rights in the earnings of the C.F.C.

- ○ Tested Loss allocated among a C.F.C.'s U.S. Shareholders is generally distributed solely with respect to the holder of a C.F.C.'s common stock, based on their proportional holdings.[4]

- A special rule addresses the allocation of Tested Loss when the shares of a C.F.C. are not held for an entire year by a U.S. Shareholder. Under the rule,[5] the Tested Loss is treated as a dividend received by another person even if an actual dividend is not made by the Tested Loss C.F.C. The effect of this rule is to reduce a U.S. Shareholder's *pro rata* share of Tested Loss in proportion to the number of days the shareholder did not own the stock of the Tested Loss C.F.C. in order to allocate to each U.S. Shareholder an amount commensurate with the economic loss borne by such person with respect to the Tested Loss.

TESTED INCOME AND TESTED LOSS

Both gross Tested Income and Subpart F Income are determined at the C.F.C. level – although, as previously mentioned, gross Tested Income is computed on an aggregate basis with regard to all C.F.C.'s. Consequently, aggregate net Tested Income of all C.F.C. subsidiaries and net Subpart F Income of each particular C.F.C. are taxed to a U.S. Shareholder on a current basis.

Use of U.S. Domestic Rules

At the C.F.C. level, the determination of gross income and allowable deductions for G.I.L.T.I. is made under procedures that are similar to the determination of Subpart

1 Prop. Treas. Reg. §1.951A-1(d)(2)(i).

2 Prop. Treas. Reg. §1.951A-1(d)(3)(i).

3 Prop. Treas. Reg. §1.951A-1(d)(3)(ii).

4 Prop. Treas. Reg. §1.951A-1(d)(4).

5 Prop. Treas. Reg. §1.951A-1(d)(4)(i)(D).

F Income. Accordingly, the Tested Income or Tested Loss of a C.F.C. is determined by treating the C.F.C. as a domestic corporation taxable under Code §11 and by applying the principles of Code §61.[6] Only items of deduction that are allowable in determining the taxable income of a domestic corporation may be taken into account for purposes of determining a C.F.C.'s net Tested Income or Tested Loss. Nondeductible expenses, such as additions to a reserve for estimated items or notional expenses, cannot be taken into account when determining the Tested Income or Tested Loss of the C.F.C. This treatment is not altered even if the item reduces the C.F.C.'s earnings and profits ("E&P"). The I.R.S. has requested comments on the application of the rules for purposes of determining Subpart F Income, Tested Income, and Tested Loss and the interactions of Code §§163(j) and 267A with Code §951A.

High-Tax Exception – Limited Application

The Proposed Regulations clarify how the high-tax exception is to be applied in the case of Tested Income. Under the high-tax exception, a U.S. Shareholder of a C.F.C. does not include in income any Subpart F Income that is subject to a high tax rate abroad. Broadly speaking, the effective rate of foreign tax on an item of income must exceed 90% of the highest rate of U.S. corporate tax on that income. In computing the effective tax rate in a foreign country, the C.F.C.'s gross income is computed by applying U.S. concepts of income and expense, not foreign concepts. Once income is computed, the actual foreign tax paid is compared with the notional U.S. tax computed under U.S. concepts. At the current corporate tax rate of 21%, the actual foreign tax must exceed 18.9% in order for the high-tax exception to be applicable. Income of a C.F.C. that would be Subpart F Income but for the high-tax exemption is excluded from Tested Income. The Proposed Regulations clarify that if the item of income of a C.F.C. is not Subpart F Income for the C.F.C., the high-tax exception is not applied in determining Tested Income. In such instance, the only tax relief available is the foreign tax credit applicable to G.I.L.T.I.

E&P Limitation

Code §952(a) identifies items of Subpart F Income. For most U.S. taxpayers, the principal item of concern is Foreign Base Company Income. Included in that category of income are Foreign Personal Holding Company Income, Foreign Base Company Sales Income, and Foreign Base Company Services Income. Subpart F Income is limited to current E&P.[7] Where that ceiling prevents the full inclusion of Subpart F Income, the benefit is recaptured from excess earnings of Subpart F Income in subsequent years. The proposed regulations address the interplay of the definitional rule and the ceiling for G.I.L.T.I. purposes. Simply stated, all income that is identified as Subpart F Income under Code §952(a) is included in gross Tested Income. Consequently, the recapture of Subpart F Income under Code §952(c)(2) is irrelevant – income that is recaptured as Subpart F Income in a subsequent year is not excluded from gross Tested Income in the recapture year.[8]

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6 Prop. Treas. Reg. §1.952-2(a)(1); Prop. Treas. Reg. §1.951A-2(c)(2), subject to the special rules in Prop. Treas. Reg. §1.952-2(c).

7 Code §952(c)(1).

8 Prop. Treas. Reg. §1.951A-2(c)(4).

Example

A domestic corporation, USCo, owns 100% of the single class of stock of a C.F.C., C.F.C. 1. USCo and C.F.C. 1 use the calendar year as the taxable year. In Year 1, C.F.C. 1 has Foreign Base Company Income of $100, a loss in foreign oil and gas extraction income of $100, and E&P of $0. C.F.C. 1 has no other income. In Year 2, C.F.C. 1 has a gross income of $100 and E&P of $100. Without regard to Code §952(c)(2), the C.F.C. has no other income in Year 2. The C.F.C. has no allowable deductions properly allocable to gross Tested Income for Year 2.

As a result of the E&P limitation of Code §952(c)(1), C.F.C. 1 has no Subpart F Income in Year 1, and USCo has no inclusion with respect to C.F.C. 1 under Code §951(a)(1)(A). The gross Tested Income of the C.F.C. is determined without regard to Code §952(c)(1). Therefore, in determining the gross Tested Income of C.F.C. 1 in Year 1, the $100 Foreign Base Company Income of the C.F.C. in Year 1 is excluded, and C.F.C. 1 has no gross Tested Income in Year 1.

In Year 2, under Code §952(c)(2), C.F.C. 1's E&P ($100) in excess of its Subpart F Income ($0) is treated as Subpart F Income. Therefore, C.F.C. 1 has Subpart F Income of $100 in Year 2, and USCo has an inclusion of $100 with respect to C.F.C. 1 under Code §951(a)(1)(A). The gross Tested Income of C.F.C. 1 is determined without regard to Code §952(c)(2). Accordingly, C.F.C. 1's income in Year 2 is not Subpart F Income, and C.F.C. 1 has $100 of gross Tested Income.

Q.B.A.I.

The Proposed Treasury Regulations provide that the Q.B.A.I. of a tested income C.F.C. for any taxable year is the average of the C.F.C.'s aggregate adjusted bases as of the close of each quarter in specified tangible property that is used in a trade or business of the corporation and of a type with respect to which a deduction is allowable under Code §167.[9] In general, specified tangible property is tangible property used in the production of Tested Income.[10] Tangible property is defined as property for which the depreciation deduction provided by Code §167(a) is eligible to be determined under Code §168 (even if the C.F.C. has elected not to apply Code §168).[11] The Proposed Regulations define tangible property by reference to property that can be depreciated under Code §168. A substantial amount of guidance exists regarding property that may be depreciated under Code §168.

Dual-Use Property

Dual-use property is treated as specified tangible property on a proportional basis[12] based on the relative amount of gross Tested Income to other gross Tested Income that the property generates for the taxable year.[13] A special rule is provided

9 Prop. Treas. Reg. §1.951A-3(b).

10 Prop. Treas. Reg. §1.951A-3(c)(1).

11 Prop. Treas. Reg. §1.951A-3(c)(2).

12 Prop. Treas. Reg. §1.951A-3(d)(1).

13 Prop. Treas. Reg. §1.951A-3(d)(2)(i).

for determining the proportion of the property treated as specified tangible property if the property generates no directly identifiable income.[14]

Example

A tested income C.F.C., C.F.C. 1, owns a machine that only packages Product A, which is acquired from a related party based in the U.S. In Year 1, C.F.C. 1 sells Product A to related and unrelated resellers for use and consumption in a third country and earns $1,000 of gross income. For Year 1, sales of Product A produce gross Tested Income of $750 and Foreign Base Company Sales Income of $250. Packaging does not meet the definition of manufacturing for purposes of Subpart F. The average adjusted basis of the machine for Year 1 in the hands of C.F.C. 1 is $4,000. C.F.C. 1 also owns an office building for its administrative functions, with an average adjusted basis for Year 1 of $10,000. The office building does not produce directly identifiable income. C.F.C. 1 has no other specified tangible property. For Year 1, C.F.C. 1 also earns $1,250 of gross Tested Income and $2,750 of Foreign Base Company Sales Income from sales of Product B. Neither the machine nor the office building is used in the production of income related to Product B. For Year 1, C.F.C. 1's gross Tested Income is $2,000 and its total gross income is $5,000.

The machine and office building are both properties for which depreciation deductions under Code §167(a) may be claimed and qualify as tangible property under Code §168. The basis in the machine allocated to specified tangible property is equal to C.F.C. 1's average basis in the machine for the year ($4,000), multiplied by the percentage that gross Tested Income produced by the property ($750) bears to the total gross income produced by the property ($1,000), or 75%. Accordingly, $3,000 ($4,000 x .75) of C.F.C. 1's adjusted basis in the machine is taken into account in determining the average of C.F.C. 1's aggregate adjusted bases. The portion of the basis in the office building treated as basis in specified tangible property is equal to C.F.C. 1's average basis in the office building for the year ($10,000), multiplied by the percentage that gross Tested Income produced by the property ($2,000) bears to the total gross income produced by the property ($5,000), or 40%. Accordingly, $4,000 ($10,000 x .40) of C.F.C. 1's adjusted basis in the office building is taken into account in determining the average of C.F.C. 1's aggregate adjusted bases in specified tangible property.

Computing Adjusted Basis

The Proposed Regulations provide that the adjusted basis in any property is determined by using the alternative depreciation system under Code §168(g) ("A.D.S.") and allocating the depreciation deduction with respect to the property ratably to each day during the period in the taxable year to which the depreciation relates. A.D.S. applies for purposes of determining Q.B.A.I. even if another depreciation method is used for other purposes of the Code. In circumstances where specified tangible property was acquired before December 22, 2017, the adjusted basis in the property is determined using A.D.S. as if this system applied from the date that the property was placed in service.[15]

[14] Prop. Treas. Reg. §1.951A-3(d)(2)(ii).

[15] Prop. Treas. Reg. §1.951A-3(e)(3).

Short Taxable Year

The Proposed Regulations provide a methodology to reduce the Q.B.A.I. of a C.F.C. with a short taxable year to an amount that would produce an amount equal to the Q.B.A.I. if annualized for a full 12-month taxable year.[16]

In determining the Q.B.A.I. of a tested income C.F.C. for a short taxable year, the quarters are the full three-month quarters beginning and ending within the short taxable year plus one or more short quarters that exist. The Q.B.A.I. is the sum of the following two amounts:

- The C.F.C.'s aggregate adjusted bases in specified tangible property as of the close of each full quarter divided by four
- The aggregate adjusted bases in specified tangible property as of the close of each short quarter, multiplied by the sum of the number of days in each short quarter, and divided by 365

Operation Through Partnerships

If a C.F.C. holds an interest in a partnership at the close of the C.F.C.'s taxable year, the C.F.C. takes into account its distributive share of the aggregate of the partnership's adjusted bases.[17] Because the term "distributive share" is used in Subchapter K of the Code only with respect to income, gain, loss, and credits of a partnership, the Proposed Regulations use the term "share" when referring to the inside basis of a partnership asset that a partner may include in its Q.B.A.I.

A C.F.C.'s share of the partnership's adjusted basis in specified tangible property is computed by reference to the partnership's average adjusted basis in the property as of the close of each quarter of the partnership's taxable year that ends with or within the C.F.C.'s taxable year.[18] Consistent with the general rule for Q.B.A.I., only a C.F.C. with Tested Income can increase its Q.B.A.I. by reason of specified tangible property owned by a partnership.[19]

A C.F.C. determines its share of a partnership's average adjusted basis in specified tangible property by reference to its distributive share of the gross income produced by the property that is included in Tested Income of the C.F.C. as a percentage relative to the total amount of gross income produced by the property.[20] If the partnership has dual-use property, similar rules to those discussed above are applied for addressing specified tangible property that does not produce any directly identifiable income. The calculation is performed separately for each item of specified tangible property held by the partnership, taking into account the C.F.C. partner's distributive share of income with respect to such property.

Anti-Abuse Provisions

Specified tangible property of a C.F.C. is disregarded for purposes of determining the average aggregate basis in specified tangible property if the property is

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16 Prop. Treas. Reg. §1.951A-3(f).

17 Code §951A(d)(1).

18 Prop. Treas. Reg. §1.951A-3(g)(3).

19 Prop. Treas. Reg. §1.951A-3(g)(1).

20 Prop. Treas. Reg. §1.951A-3(g)(2).

“A U.S. Shareholder’s Specified Interest Expense is the excess of its aggregate pro rata share of the Tested Interest Expense of each C.F.C. over its aggregate pro rata share of the Tested Interest Income of each C.F.C.”

acquired on a temporary basis at quarter-end with a principal purpose of reducing the G.I.L.T.I. inclusion amount of a U.S. Shareholder.[21] For this purpose, property held for less than a 12-month period that includes at least one quarter-end during the taxable year of a tested income C.F.C. is treated as temporarily held and acquired with a principal purpose of reducing the G.I.L.T.I. inclusion amount of a U.S. Shareholder.[22] This eliminates any opportunity for one C.F.C. to acquire tangible property from another C.F.C. to provide the transferee C.F.C. with a stepped-up basis in the transferred property, thereby increasing Prop. Treas. Reg. Q.B.A.I.[23]

TESTED INTEREST EXPENSE

To calculate a U.S. Shareholder’s net D.T.I.R., 10% of the aggregate of the U.S. Shareholder’s *pro rata* share of the Q.B.A.I. of each C.F.C.[24] is reduced by the amount of net interest expense taken into account in determining net C.F.C. Tested Income for the taxable year. This interest expense is referred to as Specified Interest Expense.[25] Specified Interest Expense is a U.S. Shareholder level determination that is net of “attributable” interest income taken into account by the U.S. Shareholder.

To be more precise, Specified Interest Expense of a U.S. Shareholder is its *pro rata* share of interest expense properly allocable to gross Tested Income reduced by its *pro rata* share of interest income that is included in gross Tested Income and attributable to that interest expense. In this way, the interest expense attributed to interest income does not reduce D.T.I.R. The effect of the computation is to reduce net D.T.I.R. by a U.S. Shareholder’s *pro rata* share of interest expense allocable to gross Tested Income. If the lender is another C.F.C. that is related to the C.F.C. and the related interest income is reflected in the U.S. Shareholder’s *pro rata* share of the Tested Income of that other C.F.C., the expense of the payor C.F.C. is not allocated to reduce gross Tested Income.

The amount of interest income “attributable” to interest expense is not defined in the Code. For administrative simplicity, a netting approach is adopted in the Proposed Regulations. Under this approach, a U.S. Shareholder’s Specified Interest Expense is the excess of its aggregate *pro rata* share of the Tested Interest Expense of each C.F.C. over its aggregate *pro rata* share of the Tested Interest Income of each C.F.C.[26] Tested Interest Expense and Tested Interest Income are generally defined by reference to all interest expense and interest income that is taken into account in determining a C.F.C.’s Tested Income or Tested Loss.[27]

A U.S. Shareholder’s Specified Interest Expense and its net D.T.I.R. and G.I.L.T.I. inclusion excludes interest income and interest expense of one or more C.F.C.’s engaged in the active conduct of a financing or insurance business, as long as the

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[21] Prop. Treas. Reg. §1.951A-3(h)(1).

[22] *Id.*

[23] Prop. Treas. Reg. §1.951A-3(h)(2).

[24] Defined as Deemed Tangible Income Return in Prop. Tres. Reg. §1.951A-1(c)(3)(ii).

[25] Prop. Treas. Reg. §1.951A-1(c)(3)(iii).

[26] Prop. Treas. Reg. §1.951A-1(c)(3)(iii)

[27] Prop. Treas. Reg. §1.951A-4(b)(1) and (2).

interest expense of the C.F.C. is incurred exclusively to fund such business with unrelated persons and not incurred to fund the acquisition of specified tangible property. Specifically, the Proposed Regulations exclude Qualified Interest Expense[28] from the definition of Tested Interest Expense. This means any interest expense of a Qualified C.F.C. – *i.e.*, an eligible C.F.C. that is in the active conduct of a banking or finance business (within the meaning of Code §954(h)(2)) or a qualifying insurance company (within the meaning of Code §953(e)(3)) – except to the extent of assets unrelated to its financing or insurance business and any interest income the Qualified C.F.C. received from loans to certain related persons. In short, the definition of Tested Interest Income is any interest income of a Qualified C.F.C. that would be included in gross Tested Income except that it is expressly excluded from Subpart F Income due to the active financing exception of Code §954(h) or the active insurance exception of Code §954(i) ("Qualified Interest Income").[29]

When computing Specified Interest Expense, the Proposed Regulations provide that interest income and interest expense should be defined broadly to encompass any amount treated as interest under the Code or regulations and any other amount incurred or recognized in a transaction or series of integrated or related transactions in which the use or forbearance of funds is secured for a period of time if the expense or loss is predominately incurred in consideration of the time value of money.[30]

Whether interest expense increases Tested Loss or reduces Tested Income, the expense is taken into account in determining a U.S. Shareholder's net C.F.C. Tested Income. To prevent a taxpayer from avoiding Specified Interest Expense by incurring offshore debt through a Tested Loss C.F.C., the Proposed Regulations confirm that any interest expense taken into account for purposes of determining the Tested Income or Tested Loss of a C.F.C. is also taken into account in determining a U.S. Shareholder's Specified Interest Expense.

DOMESTIC PARTNERSHIPS AND PARTNERS

The Proposed Regulations provide guidance to domestic partnerships and their partners on how to compute the G.I.L.T.I. inclusion amount.[31] A domestic partnership generally is defined as a partnership created or organized in the U.S. or under the law of the U.S. or a state in the U.S.[32] A domestic partnership is a U.S. person.[33] Therefore, it may be a U.S. Shareholder. This guidance also applies to S-corporations and their shareholders, as the S-corporation is treated as a partnership and its shareholders are treated as partners for purposes of Subpart F.[34]

In comparison to G.I.L.T.I., Subpart F Income is computed at the C.F.C. level. As a result, for purposes of computing the Subpart F Income of a domestic partnership that is a U.S. Shareholder, the domestic partnership includes in gross income its Subpart F inclusion amount with respect to a C.F.C., and its partners include in

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28 Prop. Treas. Reg. §1.951A-4(b)(1)(iii).

29 Prop. Treas. Reg. §1.951A-4(b)(2)(iii).

30 Prop. Treas. Reg. §1.951A-4(b)(1)(ii) and (2)(ii).

31 Prop. Treas. Reg. §1.951A-5

32 Code §7701(a)(4).

33 Code §7701(a)(30)(B).

34 Code §1373(a).

gross income their distributive share of such inclusion. Since the G.I.L.T.I. inclusion amount must be computed at the shareholder level, the above approach raises issues when the partnership and its partners are each U.S. Shareholders. The preamble to the Proposed Regulations states that the I.R.S. considered whether to apply the aggregate approach or the entity approach to the computation of the G.I.L.T.I. inclusion amount in such a case.

A pure aggregate approach would treat the partnership as an aggregate of its partners so that each partner would compute its own G.I.L.T.I. inclusion amount taking into account its *pro rata* share of C.F.C. items through the partnership. The preamble to the Proposed Regulations states that such an approach might be interpreted to exempt a U.S. person from the G.I.L.T.I. regime in circumstances where the person is not a U.S. Shareholder in its own right with respect to the C.F.C. even though the partnership of which it is a partner is a U.S. Shareholder of a C.F.C. The I.R.S. concluded that this exclusion is not clearly contemplated in Code §951A or its legislative history.

A pure entity approach would require the G.I.L.T.I. inclusion amount to be computed at the partnership level so that all U.S. persons owning a partnership interest would take into income a distributive share of the inclusion, no matter how small the interest. In the case of a partner that is a U.S. Shareholder with respect to C.F.C.'s owned through the partnership and outside of the partnership, its G.I.L.T.I. inclusion amount would be fragmented. That is, instead of computing the G.I.L.T.I. inclusion amount at the shareholder level for all of the C.F.C.'s held by the U.S. Shareholder partner, the G.I.L.T.I. inclusion amount would be computed at the shareholder level for C.F.C.'s held directly and at the partnership level for C.F.C.'s held through U.S. Shareholder partnerships.

"A domestic partnership is treated as an entity with respect to partners that are not U.S. Shareholders of any C.F.C.'s owned by the partnership . . . [and] as an aggregate for the purposes of partners that are U.S. Shareholders."

Again, the I.R.S. concluded that this result is not supported by the statutory framework of Code §951A. The provision requires a shareholder level computation of the G.I.L.T.I. inclusion amount. Moreover, the problems with a pure entity approach are accentuated when the partner is a U.S. Shareholder. Certain provisions in the G.I.L.T.I. regime apply to a corporate U.S. Shareholder that would not work if a partnership were treated as the sole U.S. person in the ownership chain. Examples are Code §250, which provides corporations with a tax rate equivalent deduction for a G.I.L.T.I. inclusion, and Code §960(d), which provides an indirect foreign tax credit for corporations that are U.S. Shareholders of a C.F.C. in connection with an income inclusion under Subpart F.

The Proposed Regulations adopt a blended approach in the case of a partnership or S-corporation that is a U.S. Shareholder of a C.F.C. having Tested Income that can result in a G.I.L.T.I. inclusion. Under the blended approach, a domestic partnership is treated as an entity with respect to partners that are not U.S. Shareholders of any C.F.C.'s owned by the partnership. At the same time, it is treated as an aggregate for the purposes of partners that are U.S. Shareholders of one or more C.F.C.'s owned by the partnership.

According to the preamble that accompanied the Proposed Regulations, this approach ensures that each non-U.S. Shareholder partner takes into income its distributive share of the domestic partnership's G.I.L.T.I. inclusion amount (similar to the way it would include Subpart F Income), while permitting a partner that is itself a U.S. Shareholder to determine a single G.I.L.T.I. inclusion amount with reference to all C.F.C.'s it owns, whether directly or through a domestic partnership. The

I.R.S. has requested comments on whether any other approach would be more appropriate in harmonizing the provisions of the G.I.L.T.I. regime. It also requested comments on adjustments that might be required at the level of the partner of a domestic partnership by reason of computing a G.I.L.T.I. inclusion amount. Possible adjustment items include

- a partner's basis in a partnership interest,
- a partner's Code §704(b) capital account (relating to book-ups of capital accounts),
- a partnership's basis in C.F.C. stock under Code §961 (relating to adjustments in the basis of C.F.C. stock, such as increases in basis as a result of recognizing Subpart F Income or decreases in basis as a result of receiving a distribution of previously taxed income), and
- a C.F.C.'s previously taxed E&P with respect to the partner or partnership under Code §959 (relating to the exclusion of gross income of the C.F.C.'s previously taxed E&P).

TREATMENT OF G.I.L.T.I. INCLUSION AMOUNTS AND ADJUSTMENTS TO E&P AND BASIS

Treatment of G.I.L.T.I. as Subpart F Income for Certain Purposes

G.I.L.T.I. has a form of split personality disorder for U.S. tax purposes. On one hand, a U.S. Shareholder's G.I.L.T.I. inclusion amount is not an inclusion under Code §951(a)(1)(A), which states that a U.S. Shareholder of a C.F.C. must include Subpart F Income in its gross income for the current year. On the other hand, for the purposes of applying numerous Code sections outside of the G.I.L.T.I. regime, G.I.L.T.I. inclusion amounts are treated in a way that is similar to Subpart F inclusion amounts.[35] The I.R.S. has been granted authority to issue guidance on how various Code sections will apply to G.I.L.T.I. inclusion amounts.[36] Under that authority, the Proposed Regulations state that the G.I.L.T.I. inclusion amounts are "net investment income" for the purpose of applying Code §1411 since Subpart F Income is subject to that Code section. Code §1411 imposes a 3.8% tax on the net investment income of U.S. persons that are individuals, trusts, and estates. The tax is imposed in addition to the U.S. income tax capital gain.

Interaction with Code §§267(a)(3)(B) and 163(e)(3)(B)(i)

Code §267(a)(3)(B) generally provides that a deduction for an item payable to a related C.F.C. is not allowed to a U.S. person until such time as payment is made or includible in the gross income of a U.S. Shareholder (determined without regard to properly allocable deductions and qualified deficits). Code §163(e)(3)(B)(i) provides a similar rule for original issue discount on a debt instrument held by a related C.F.C. Original issue discount exists to the extent periodic payments of interest are deferred. The Proposed Regulations state that these deduction deferral rules should not apply to the extent an item is taken into account in determining a U.S.

[35] Code §951A(f)(1)(A).

[36] Code §951A(f)(1)(B).

Shareholder's G.I.L.T.I. inclusion amount. Thus, a deduction is allowed under Code §§267(a)(3)(B) and 163(e)(3)(B)(i) for an item taken into account in determining the net C.F.C. Tested Income of a U.S. Shareholder.[37]

This rule also applies to a U.S. Shareholder treated as directly or indirectly owning stock of a C.F.C. owned by a domestic partnership. However, in the case of a U.S. Shareholder that is a domestic partnership, this rule applies in two circumstances. The first is where one or more U.S. persons (other than domestic partnerships) that are direct or indirect partners of the domestic partnership include in gross income their distributive share of the partnership's G.I.L.T.I. inclusion amount. The second is where the item is taken into account by a U.S. Shareholder partner of the domestic partnership by reason of the Proposed Regulations applying the aggregate method to determine the G.I.L.T.I. inclusion amount of a U.S. Shareholder partner discussed above.[38]

Basis Adjustments for the Use of Tested Losses

In determining a U.S. Shareholder's net C.F.C. Tested Income, the U.S. Shareholder's *pro rata* share of a Tested Loss of one C.F.C. may offset the shareholder's *pro rata* share of Tested Income of another C.F.C. However, under the statute, such a use of a Tested Loss does not reduce the U.S. Shareholder's basis in the stock of the Tested Loss C.F.C., increase the stock basis of the tested income C.F.C., or affect the E&P of either the Tested Loss C.F.C. or the tested income C.F.C.

The preamble to the Proposed Regulations provides an example in which the lack of basis adjustment can lead to inappropriate results. In the example, the U.S. Shareholder's basis in the stock of the Tested Loss C.F.C. is not reduced to reflect the use of the Tested Loss to offset Tested Income taken into account by the U.S. Shareholder. Upon a subsequent disposition of the Tested Loss C.F.C., the U.S. Shareholder would recognize a duplicative benefit either through the recognition of a loss or the reduction of gain.[39] The basis reduction is only made at the time of the disposition and therefore does not affect the stock basis prior to a disposition. Requiring the basis reduction only at the time of the disposition prevents the use of Tested Losses alone from causing the recognition of gain if the reduction exceeds the amount of stock basis.

The basis adjustments apply only to the extent a "net" Tested Loss of the C.F.C. has been used. This limitation is intended to ensure that the reduction applies only to the extent necessary to eliminate the duplicative loss in the stock. The following example illustrates this feature of the rule.

Example

A U.S. Shareholder holds interests in two C.F.C.'s, C.F.C. 1 and C.F.C. 2. In Year 1, C.F.C. 1 has a Tested Loss of $100x. This Tested Loss offsets $100x of Tested Income of C.F.C. 2 when determining the U.S. Shareholder's net C.F.C. Tested Income. In Year 2, C.F.C. 1 has $20x of Tested Income that is used to offset a $20x Tested Loss of C.F.C. 2. In this circumstance, adjustments are made to limit the effect of the Tested Income and Tested Loss

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[37] Prop. Treas. Reg. §1.951A-6(c)(1).

[38] Prop. Treas. Reg. §1.951A-6(c)(2).

[39] Prop. Treas. Reg. §1.951A-6(e).

of the two C.F.C.'s to recognize the effect of the flip of Tested Income and Tested Loss reported by the two C.F.C.'s. On a retroactive basis, the $100x used Tested Loss attributable to the C.F.C. 1 stock from Year 1 is reduced by the $20x of its Tested Income from Year 2 that was offset by the Tested Loss of C.F.C. 2, resulting in a "net" used Tested Loss of $80x.[40]

In the case of a direct disposition of C.F.C. stock that results in the indirect disposition of the stock of one or more lower-tier C.F.C.'s, basis adjustments may be made to both the stock of the upper-tier C.F.C. and the stock of the lower-tier C.F.C.'s.[41] The Proposed Regulations provide ordering rules for making these adjustments that generally are intended to prevent gain resulting from a basis adjustment attributable to the use of a single Tested Loss from being taken into account more than once.[42]

In the case of certain nonrecognition transactions involving C.F.C.'s, the Proposed Regulations provide rules intended to prevent the elimination or avoidance of the basis adjustment rules discussed above through the use of nonrecognition transactions.

The preamble to the Proposed Regulations request comments on whether similar rules should apply to non-corporate U.S. Shareholders, taking into account the fact that non-corporate U.S. Shareholders are not entitled to the Code §245A D.R.D. Comments are also requested on whether the definition of "disposition" should be modified, such as broadening the term to include transactions that do not involve an actual transfer of stock but might result in taxable gain but for the presence of tax basis in C.F.C. stock. Examples of such transactions include distributions subject to Code §301(c)(2) (relating to distributions to shareholders not attributable to accumulated or current E&P and that result in the reduction of stock basis).

PROPOSED MODIFICATIONS TO REGULATIONS UNDER CODE §951

Pro Rata Share Rules

Final regulations under Code §951 contain rules to address certain avoidance structures, such as structures that result in non-economic allocations of Subpart F Income to shareholders of C.F.C.'s that are not U.S. Shareholders. Prop. Treas. Reg. §1.951-1(e) would address additional avoidance structures that implicate Code §951A (as well as Code §951). The following changes to the *pro rata* share rules are included in the regulations:

- For purposes of determining a U.S. Shareholder's *pro rata* share of Subpart F Income, E&P for the tax year is first hypothetically distributed among the classes of stock and then hypothetically distributed to each share in the class on the hypothetical distribution date, which is the last day of its tax year on which it is a C.F.C. The amount of E&P that would be distributed with respect to classes of stock would be based on all relevant facts and circumstances.[43]

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[40] Prop. Treas. Reg. §1.951A-6(e)(2).

[41] Prop. Treas. Reg. §1.951A-6(e)(6)(ii)(B).

[42] Prop. Treas. Reg. §1.951A-6(e)(1)(iv).

[43] Prop. Treas. Reg. §1.951-1(e)(3).

Under the current regulations, the E&P allocations between classes of stock with discretionary distribution rights are based on the fair market value of the stock. The I.R.S. views this rule as susceptible to manipulation because taxpayers can allocate E&P to classes of stock that have a fair market value that has been inflated because they include preferred distribution or liquidation rights.

- Existing Subpart F rules[44] will be modified in order to take into account Code §951A in certain ways. The Proposed Regulations provide that a U.S. Shareholder's *pro rata* share of a C.F.C.'s Subpart F Income is determined by reference to its proportionate share of the total current E&P that would be distributed in a hypothetical distribution at the end of the year. That hypothetical distribution also applies to the shareholder's *pro rata* share of a C.F.C.'s Tested Income.[45] However, certain adjustments must be made to reflect the specific rules under Code §951A. Thus, because (i) Tested Income is not limited to the E&P of a C.F.C. and (ii) a C.F.C.'s Tested Loss increases its E&P for purposes of determining the Subpart F Income limitation in Code §952(c)(1), the E&P allocated in the hypothetical distribution may exceed the E&P of the C.F.C. computed under Code §964. Accordingly, the hypothetical distribution in the Proposed Regulations is based on the greater of (i) the Code §964 E&P or (ii) the sum of the Subpart F Income (increased by any Tested Loss add-back)[46] and Tested Income of the C.F.C.
- More broadly, any transaction or arrangement that is part of a plan that has as a principal purpose the reduction of a U.S. Shareholder's *pro rata* share of the Subpart F Income of a C.F.C. is disregarded.[47]

These rules would apply to tax years of a U.S. Shareholder ending on or after October 3, 2018.

"The Proposed Regulations would treat certain controlled domestic partnerships as foreign partnerships for purposes of identifying a U.S. Shareholder for purposes of applying the Subpart F and G.I.L.T.I. rules."

Partnership Blocker Structures

In 2010, the I.R.S. issued a notice, applicable in specific circumstances, stating that regulations would be issued calling for a domestic partnership to be treated as a foreign partnership when identifying the specific U.S. Shareholder required to include in gross income a *pro rata* share of a C.F.C's Subpart F Income.[48] Of concern to the I.R.S. was a situation in which (i) a U.S. taxpayer-owned two C.F.C.'s, C.F.C.1 and C.F.C. 2, and (ii) each of C.F.C. 1 and C.F.C. 2 owned 50% of a third C.F.C., C.F.C. 3, through a domestic partnership. The Subpart F Income of C.F.C. 3 flowed to the domestic partnership as the first U.S. Shareholder in the ownership chain. As a result, the domestic partnership acted as a blocker of Subpart F Income.

Following the notice, the Proposed Regulations would treat certain controlled domestic partnerships as foreign partnerships for purposes of identifying a U.S. Shareholder for purposes of applying the Subpart F and G.I.L.T.I. rules.[49]

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44 Prop. Treas. Reg. §1.951-1(e).

45 Prop. Treas. Reg. §1.951A-1(d)(2).

46 Code §951A(c)(2)(B)(ii) and Prop. Treas. Reg. §1.951A-6(d).

47 Prop. Treas. Reg. §1.951-1(e)(6).

48 Notice 2010-41, 2010-22 I.R.B. 715.

49 Prop. Treas. Reg. §1.965-1(e).

These rules would apply to tax years of domestic partnerships beginning on or after May 14, 2010, and before January 1, 2018 (consistent with the 2010 Notice, discussed above).[50] For Code §951A purposes, the Proposed Regulations would apply to tax years of domestic partnerships beginning after December 31, 2017.

New Reporting Requirements

To report information and tax computations with respect to G.I.LT.I., U.S. Shareholders must file certain forms:

- New Schedule I-1, *Information for Global Intangible Low-Taxed Income*, as a schedule to Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*[51]
- New Form 8992, *U.S Shareholder Calculation of Global Intangible Low-Taxed Income (G.I.L.T.I.)*[52]

Notably, the rules that set forth the above filing requirements are proposed to apply to tax years of foreign corporations beginning on or after October 3, 2018.

Applicability Dates

Except as otherwise discussed above, the Proposed Regulations under Code §§951 and 951A apply to the tax year of the foreign corporation beginning after December 31, 2017, and the tax year of the U.S. Shareholder in which such tax year of the foreign corporation ends.

CONCLUSION

The T.C.J.A. moved U.S. tax policy for profitable international operations in the direction of current taxation but at a lower rate. In so doing, it introduced new terms to U.S. tax law but did so in a summary way. The Proposed Regulations fill in the gap between policy and practice.

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50 This means that the transition tax under Code §965 will apply to the partnership arrangement that holds an interest in a C.F.C.

51 See Prop. Treas. Reg. §1.6038-2(a).

52 See Prop. Treas. Reg. §1.6038-5.

C-CORPS EXEMPT FROM FULL SCOPE OF FOREIGN INCOME INCLUSION

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Tags
C-Corporation
Code §956
D.R.D.
T.C.J.A.

On October 31, 2018, the I.R.S. proposed regulations affecting controlled foreign corporations ("C.F.C.'s") and U.S. corporations that are considered to be U.S. Shareholders, as defined, when a C.F.C. makes an investment in U.S. property. In substance, the proposed regulations adopt a simple exception to U.S. tax exposure for a U.S. corporation that is a U.S. Shareholder of a C.F.C. – if the C.F.C. were to distribute a hypothetical dividend to the U.S. Shareholder that would benefit from the 100% D.R.D. upon receipt, the taxable investment in U.S. property will be reduced by an amount that is equivalent to the D.R.D. allowed in connection with the hypothetical dividend.[1]

Background Definitions

A foreign corporation is a C.F.C. under one of two tests.[2] The first is that stock representing more than 50% of the total combined voting power of all classes of stock entitled to vote is owned by one or more U.S. Shareholders on any day during the taxable year. The second is that stock representing more than 50% of the total value of all stock of the foreign corporation is owned by one or more U.S. Shareholders on any day during the taxable year. The ownership may be direct,[3] indirect through foreign entities,[4] or constructive[5] for this purpose.

A U.S. Shareholder is a U.S. person that owns directly or indirectly, or is considered to own under the constructive ownership rules mentioned above, either

- stock representing 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or
- stock representing 10% or more of the total value of shares of all classes of stock of the foreign corporation.[6]

In general,[7] a U.S. person is a citizen or resident of the U.S., a domestic partnership, a domestic corporation, a domestic estate and a domestic trust.[8]

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1. Prop. Treas. Reg. §1.956-1(a)(2).
2. Code §957(a). A special rule applies in the context of an insurance company. There, the ownership level is reduced to more than 25%.
3. Code §958(a)(1).
4. Code §958(a)(2).
5. Code §958(b).
6. Code §951(b).
7. Code §957(c). Special rules apply when a U.S. citizen owns shares in a corporation organized in Guam, American Samoa, the Northern Mariana Islands, or the Commonwealth of Puerto Rico.
8. Code §7701(a)(30).

> **"If the C.F.C. were to distribute a hypothetical dividend to the U.S. Shareholder that would benefit from the 100% D.R.D. upon receipt, the taxable investment in U.S. property will be reduced."**

Subject to a series of exceptions, U.S. property consists of the following four items:

- Tangible property located in the U.S.
- Stock of a domestic corporation
- An obligation of a U.S. person
- Any right to the use in the U.S. of a patent or copyright, an invention, model or design (whether or not patented), a secret formula or process, or any other similar property right, which is acquired or developed by the C.F.C. for use in the U.S.

The exceptions generally are intended to promote certain U.S. businesses carried on by third parties.[9]

Investment in U.S. Property Rules

Code §956 was enacted as part of the Subpart F regime to ensure that a C.F.C.'s earnings not subject to immediate tax under Subpart F when earned would be taxed when repatriated, either through a dividend or an effective repatriation arrangement not considered to be a dividend. Hence, it was crafted to prevent the repatriation of income to a U.S. Shareholder in a manner that is not immediately taxable. Examples of items that would not be taxed at the level of a shareholder but for the application of Code §956 include, but are not limited to, acquisitions of stock or debt obligations of a related U.S. person or its domestic affiliates.

Both investments make funds available for use by the U.S. Shareholder of a C.F.C. and, for that reason, constitute an effective repatriation of earnings that should be taxed. Each of these investments serves as the functional equivalent of a dividend and should be taxed as a dividend. In sum, Code §956 ensures functional symmetry in the tax treatment of repatriations through dividends and equivalent transactions.

100% D.R.D. Eliminates Need for Anti-Abuse Rule

Prior to the enactment of the T.C.J.A. (Tax Cuts and Jobs Act of 2017), U.S. citizens, U.S.-resident individuals, and domestic corporations were taxed on dividends received from foreign corporations. This parity of tax treatment for individuals and corporations was broken by the enactment of Code §245A. Code §245A provides certain domestic corporations with a 100% deduction for the foreign-source portion of dividends received from specified 10%-owned foreign corporations, provided that certain conditions are met:

- The domestic corporation must meet the ownership threshold to be a U.S. Shareholder and must have the status of a taxable C-corporation. As a result, a registered investment company, a real estate investment trust, and an S-corporation cannot benefit from the 100% D.R.D.
- The foreign corporation must be a specified 10%-owned foreign corporation. This is any foreign corporation other than a passive foreign investment company.[10]

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[9] Code §956(c)(2).

[10] If the P.F.I.C. is a C.F.C. and a C-corporation is a U.S. Shareholder of the C.F.C., the P.F.I.C./C.F.C. overlap rule treats the foreign corporation as if it is

- The shares of the 10%-owned foreign corporation must meet a period-of-ownership threshold in the hands of the C-corporation. The shares must be held for at least 365 days during the 731-day period beginning on the date that is 365 days before the ex-dividend date.[11]

- The domestic corporation must not be under an obligation to make related payments with respect to positions in substantially similar or related property.[12]

- The dividend must not be a hybrid dividend,[13] which broadly means that the dividend cannot give rise to a deduction for the specified foreign corporation, nor can it trigger another tax benefit for the specified foreign corporation.[14]

In light of the D.R.D. allowed to C-corporations, the I.R.S. determined that broad application of Code §956 to corporate U.S. Shareholders of C.F.C.'s is inconsistent with the purposes of that section now that certain dividends can be received from a C.F.C. without any tax. In the absence of the proposed regulations, a U.S.-parented group in many cases would need to engage in complex and costly restructuring upon the acquisition of a foreign corporation that owns domestic subsidiaries, because the foreign corporation would become a C.F.C. and the stock of its domestic subsidiaries would represent U.S. property. Absent the proposed regulations, Code §956 could also serve as a "trap for the unwary'' for any domestic corporation that fails to recognize that, notwithstanding the deduction under Code §245A for actual dividends, Code §956 inclusions would continue to be fully subject to U.S. tax.

Similar considerations are absent in the context of individuals and certain corporations that are not entitled to claim the D.R.D.

Proposed Regulations

In general, under Code §245A and the proposed regulations, neither an actual dividend to a corporate U.S. Shareholder nor an amount determined under Code §956 to a corporate U.S. Shareholder will be taxed.

To achieve this result, the proposed regulations provide that the amount otherwise determined under Code §956 with respect to a U.S. Shareholder for a taxable year of a C.F.C. will be reduced to the extent that the U.S. Shareholder would be allowed a deduction under Code §245A if the U.S. Shareholder received a hypothetical distribution from the C.F.C. in an amount equal to the amount determined under Code §956. Due to the broad application of Code §245A, in many cases a corporate U.S. Shareholder will not have a Code §956 inclusion as a result of a C.F.C. holding U.S. property under the proposed regulations. The proposed regulations provide special rules with respect to indirect ownership.

As mentioned above, Code §956 will continue to apply without modification to U.S. Shareholders other than C-corporations to ensure that, consistent with the purposes of Code §956, an investment in U.S. property that is substantially the equivalent of

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not a P.F.I.C. but does so only because the U.S. Shareholder faces immediate taxation under Subpart F with regard to the C.F.C.'s Subpart F Income.

[11] Code §§246(c)(1) and (5).

[12] Code §246(c)(1)(8).

[13] Code §245A(e)(1).

[14] Code §245(e)(4).

a dividend will be treated in a manner that is similar to an actual dividend. This treatment will apply to individuals even if they make an election under Code §962 to be taxed as a corporation. Individuals making the election are not eligible for the D.R.D. when an actual dividend is received. Similarly, Code §956 will continue to apply fully to registered investment companies, or R.I.C.'s, and real estate investment trusts, or R.E.I.T.'s, because neither is allowed the dividends received deduction under Code §245A.[15]

Effective Date

The proposed regulations will apply (i) to taxable years of a C.F.C. beginning on or after the date the U.S. Department of the Treasury decision adopting final regulations are published in the Federal Register and (ii) to taxable years of a U.S. Shareholder in which or with which such taxable years of the C.F.C. end. With respect to taxable years of a C.F.C. beginning before the publication date in the Federal Register, a taxpayer may rely on the proposed regulations for taxable years of a C.F.C. beginning after December 31, 2017, and taxable years of a U.S. Shareholder in which or with which such taxable years of the C.F.C. end, provided that the corporate taxpayer and all related persons apply the proposed regulations on a consistent basis with respect to all C.F.C.'s in which they are U.S. Shareholders.

Hence, the proposed regulations remove U.S. C-corporations from the full scope of Code §956 when actual dividends are not otherwise taxable. On the other hand, the full scope of Code §956 continues to apply to R.I.C.'s, R.E.I.T.'s, S-corporations, citizen and resident individuals, U.S. domestic estates, and U.S. domestic trusts.

15 Code §§852(b)(2)(c) and Code 857(b)(2)(A).

HOW TO HANDLE DUAL RESIDENTS: THE I.R.S. VIEW ON TREATY TIE-BREAKER RULES

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The first step in advising a foreign individual who is neither a U.S. citizen nor a green card holder on U.S. income tax laws is to determine the person's residence for income tax purposes. But what is to be done when the individual is resident in multiple jurisdictions? For this purpose, U.S. domestic law, foreign law, and residency rules under any applicable income tax treaty must be looked at.

One useful resource is the International Practice Units published by the I.R.S. Large Business and International Division ("LB&I"). These training aids for examiners provide taxpayers with some insights into the areas on which the I.R.S. will focus during an examination. However, they cannot be used or cited by taxpayers as precedent.

The Practice Unit "Determining an Individual's Residency for Treaty Purposes" was published on July 3, 2018. It provides guidance on how to determine tax residency under an applicable U.S. income tax treaty.

Treaties generally have a provision for determining residency in the case of dual residency in both the U.S. and the treaty partner country. These rules are often referred to as the Tie-Breaker Rules.

The Practice Unit summarizes the steps for applying the Tie-Breaker Rules as follows:

1. Determine whether the individual properly claimed to be a U.S. resident under domestic U.S. tax law.
2. Determine whether the individual properly claimed to be a resident of a treaty partner.
3. Apply the treaty Tie-Breaker Rules in a case of dual residency.

The Practice Unit uses Article 4, the Residency Article, of the 2006 U.S. Model Income Tax Convention ("2006 U.S. Model Treaty")[1] for illustration purposes and explicitly advises that every treaty is different and will thus have to be analyzed separately. Further, it advises to carefully review any additions or governmental comments on a treaty.[2]

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1 The most recent version of the U.S. Model Income Tax Convention was released on February 17, 2016. However, as of this publication, no technical explanation of the treaty have been published.

2 The I.R.S. expressly refers to treaty protocols, memoranda of understanding or exchanges of notes, technical explanations from the Treasury Department, Joint Committee on Taxation reports on a treaty, Senate Foreign Relations Committee report on a treaty, relevant case law, competent authority agreements, and guidance issued by the I.R.S.

STEP 1 – U.S. RESIDENCY CLAIM

The Practice Unit starts by reminding that, under U.S. domestic law, a person is a U.S. resident if such person (i) is a U.S. citizen, (ii) is a U.S. green card holder, (iii) is a U.S. resident under the Substantial Presence Test,[3] or (iv) makes a first-year election to be treated as a U.S.-resident individual.

In addition to Code §7701(b)(1), which contains the definitions of resident and non-resident aliens, the Practice Unit surprisingly quotes *Lujan v. Comm'r.*[4] and I.R.S. Info. Letter 2013-0021[5] instead of simply referencing the Treasury Regulations under §7701(b)(1).

- In *Lujan v. Comm'r.*, the Tax Court dealt with the Substantial Presence Test and concluded, in relevant part, that the taxpayer incorrectly failed to include the date of exit from the U.S. and the date of entry into the U.S. for purposes of the test.
- I.R.S. Info. Letter 2013-0021 examines the residency rules of the U.S.-German Income Tax Treaty. (That treaty's Residency Article is the same as Article 4 the 2006 U.S. Model Treaty.) The letter then turns to Code §7701(b)(1) and the regulations thereunder to determine U.S. residency.

  The letter constitutes a comprehensive tool for I.R.S. agents applying the Substantial Presence Test. It (i) lays out the general definition of U.S. residents, (ii) looks at the general Substantial Presence Test rules, (iii) explains the Closer Connection Test exception, (iv) cites the rules that disregard certain days of presence under the Substantial Presence Test because the individual is either an "exempt individual" or continues to stay in the U.S. because of a medical condition preventing him or her from leaving, and (v) looks at the first-year election.

I.R.S. agents are instructed to look for U.S. residency indicia by proceeding as follows:

- When an individual files a Form 1040 NR, *U.S. Nonresident Alien Income Tax Return*, the Practice Unit points out that a closer look at items B to H of Schedule OI (Other Information) can help I.R.S. agents determine U.S. residency.
- Agents are also instructed to look for Form I-551, *Alien Registration Receipt Card*, also known as the green card.

The Practice Unit provides residency starting date and ending date guidelines for green card holders and for Substantial Presence Test purposes. For green card holders, I.R.S. agents are reminded that green card status is ended

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3 Generally, a foreign individual is treated as a U.S. resident for income tax purposes if he or she is present in the U.S. 183 days or more during a rolling three-year period. However, an exception may apply (*e.g.*, the Closer Connection Test) under U.S. domestic law.

4 T.C. Memo 2000-365.

5 I.R.S. Info. Letter 2013-0021 (March 28, 2013).

- by filing either (i) U.S.C.I.S. Form I-407 or (ii) a letter stating the taxpayer's intent to abandon his or her green card along with U.S.C.I.S. Form I-551 with a U.S.C.I.S. or consular officer, or
- pursuant to Code §7701(b)(6), if the taxpayer (i) starts to be treated as a resident of a country other than the U.S. under a tax treaty, (ii) does not waive treaty benefits, and (iii) notifies the I.R.S. of his or her residency status by filing a Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

With respect to the latter, notably, taxpayers should be careful about filing a treaty return position claiming non-U.S. residency when they hold a green card, since this could trigger an exit tax exposure. Towards the end of the Practice Unit, this potential exit tax exposure is explicitly pointed out.

"Taxpayers should be careful about filing a treaty return position claiming non-U.S. residency when they hold a green card, since this could trigger an exit tax exposure."

For treaty purposes, the Practice Unit states that, pursuant to Article 4 of the 2006 U.S. Model Treaty and the Treasury explanations thereunder, a U.S.-resident individual is defined the same way as under U.S. domestic law with one exception: A non-U.S. person married to a U.S. citizen or U.S. resident can elect to be treated as a U.S. resident for income tax purposes. Such an election disqualifies the individual from claiming the benefit of the Tie-Breaker Rules.[6]

Finally, the Practice Unit cautions that certain treaties require additional tests to be met in order for a U.S. citizen or green card holder to be considered as a U.S. resident. For example, the individual may be required to

- have a substantial presence, permanent home, or habitual abode in the U.S. and not be treated as a resident of a third country under a treaty between the other contracting state and that third country, or
- have a substantial presence in the U.S. or be a resident of the U.S. and not a resident of the third country under the Tie-Breaker Rules.

The Practice Unit cites the U.S.-U.K. and U.S.-France treaties as examples in this context.

The Practice Unit concludes that for purposes of Step 1, the agent must determine whether the individual is a U.S. resident both under U.S. domestic law and under the treaty.

STEP 2 – TREATY COUNTRY RESIDENCY CLAIM

In order to determine whether an individual properly claimed residence in a treaty country, the Practice Unit advises that I.R.S. agents should look for the following:

- Information on tax returns, *e.g.*, responses on Schedule OI of Form 1040NR
- Responses on Form 9210, *Alien Status Questionnaire*
- The exchange of information provisions available under the treaty, or tax information exchange agreements, that can be used to receive information from outside the U.S.

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6 Treas. Reg. §1.6013-6(a)(2)(v).

- A foreign equivalent to a certificate of residency[7]
- The presence of a "*forfait*" or another fixed-fee regime[8]

STEP 3 – TREATY TIE-BREAKER RULES

I.R.S. agents move to Step 3 if they determine that the individual is a resident of the other country for treaty purposes and also a resident of the U.S. If not, the agents are asked to skip Step 3 and go to the section entitled "Other Considerations or Impact to Audit."

The Tie-Breaker Rules are used to determine a single country of residence in a case of dual residency. Citing the 2006 U.S. Model Treaty, the Practice Unit provides that the Tie-Breaker Rules generally look at the following factors:

1. The existence and location of a permanent home
2. The center of vital interests
3. The individual's habitual abode
4. Nationality[9]

The Tie-Breaker Rules test these factors in the stated order. Once an element has been satisfied with respect to the U.S. or the treaty country, residency is attributed accordingly. If the test is met for both countries, the next factor is tested.

The I.R.S. cautions that not all treaties have Tie-Breaker Rules and cites the U.S.-China and the U.S.-Pakistan treaties as examples. While not stated in the Practice Unit, residency would, in these cases, be determined under a competent authority procedure (*i.e.*, in consultations between the competent authorities of the two countries in issue).[10]

Permanent Home

Under the Tie-Breaker Rules, an individual has a permanent home in the U.S. if

- the individual (i) purchased a home in the U.S., (ii) intended to reside in that home for an indefinite time, and (iii) actually did reside in that home; or

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7 In this respect, the I.R.S. cautions that the certificate can only be relied on if a reasonably prudent person would not doubt the certificate. Absent such a certificate, the Practice Unit requires agents to (i) consider the other country's domestic laws of residency and (ii) evaluate the individual's specific facts in light of those rules. It recommends using the BNA Tax Management Portfolios and the information found on the websites of accounting firms.

8 Here, the I.R.S. gives Switzerland and Ireland as examples.

9 Note that a similar test exists under U.S. domestic law as an exception to the-Substantial Presence Test (Treas. Reg. §§301-7701(b)-2(a)(1)). If the taxpayer can substantiate closer connections to a single foreign country in line with the rules of the domestic Closer Connection Test, residency will be assigned to the foreign country. This test does not apply if the taxpayer has been in the U.S. for 183 days or more in the current year.

10 Cf. U.S.-China Income Tax Treaty, art. 4(2) for dual resident individuals and art. 4(3) for dual resident corporations.

- the individual (i) has a room or apartment continuously available, (ii) stores personal property (*e.g.*, automobiles or personal belongings) at the dwelling, and (iii) conducts business (*e.g.*, maintaining an office, registering a telephone), including using the address for insurance and a driver's license.

Certain treaties look at an individual's family life to determine a permanent home. The Practice Unit cites the U.S.-Australia, U.S.-Indonesia, and U.S.-Korea treaties.

If the individual has only one permanent home, the application of the Tie-Breaker Rules ends there. If the individual has a permanent home in both treaty countries, the individual's center of vital interests must be determined.

Center of Vital Interests

To determine an individual's center of vital interests, one must look at their personal, community, and economic relations. The following factors are not exclusive. Rather, all facts and circumstances are relevant and must be evaluated in their entirety.

- An individual's personal relations can be identified (i) by such individual's family location, including parents and siblings, and where the individual spent his or her childhood, or (ii) in the case of a person's recent relocation, by whether the family moved from their permanent home to join the individual or the individual located to a second state. However, certain treaties, like the U.S.-Israel treaty, have a different definition of the center of vital interests.
- An individual's community relations are determined by the location of the individual's (i) health insurance, (ii) medical and dental professionals, (iii) driver's license or motor vehicle registration, (iv) health club membership, (v) political and cultural activities, and (vi) ownership of bank accounts.
- A person's economic relations are identified by where the individual (i) keeps his or her investments or conducts business, (ii) incorporated a business, and (iii) retains professional advisors (*e.g.*, attorneys, agents, and accountants).

Habitual Abode

An individual's habitual abode is the place where the individual has a greater presence during the calendar year.

Nationality

An individual's nationality is determined by their citizenship or state of nationality. An individual is unlikely to be a U.S. national if they are not a U.S. citizen.

To determine the individual's state of nationality, agents should look to passports and/or U.S.C.I.S. Forms I-94, and reconcile these documents with the individual's Form 1040NR, Schedule OI, Item A, which inquires about the filer's citizenship. An exchange of information request may also be submitted.

BEYOND STEP 3

If, after applying these tests, the individual still has dual residency, the competent authorities will try to assign a residency country by means of mutual agreement.

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Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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